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Strengthening Bank and Non-Bank Institutions in the Republic of Macedonia

Volume I - Assessment Report

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USAID

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Note:

This diagnostic was done under RFQ 165-02-08. An opinion was given on November 29, 2001 by Szilvia Illes that performance of this assessment would not preclude the contractor from performing work emanating from potential opportunities.

I. Introduction

A. Background

This financial sector assessment has been conducted by KPMG Barents Group at the request of the United States Agency for International Development under IQC No. PCE-I-00-99-00006-00. The team consisted of Michael Borish (Chief of Party), Scott Trapani (Financial Services Supervision expert), and Stewart Kemp (Insurance and Pension expert). The entire team would like to thank the many people in the Republic of Macedonia (RM) who were kind enough to provide time and information in support of the overall effort. The team wishes to express its gratitude for the support provided by USAID in Macedonia. Particular thanks go out to Stephen Haynes (USAID Resident Representative), Steve Gonyea (Director, Private Sector Development Office), Sharon Hester (Private Sector Development Officer), and Elizabeth Markovik (Project Management Specialist) from the USAID-Republic of Macedonia office, and Suzanne Nolte from USAID-Washington. The team also wishes to thank Les Sweeting and Ana Zabevska of the KPMG-Barents office in Skopje for their generous assistance. A list of key meetings is found in Annex 5 of the assessment. The team visited RM from January 15-January 29, 2002 in conjunction with the assignment.

B. Organization of the Assessment

Chapter II provides background to the current state of the financial sector in RM. This includes a review of major past developments, as well as some comparative figures regarding RM's performance with those of other transition countries. Chapter III provides a brief overview of the major legal, regulatory and institutional issues related to the financial sector. This includes laws and regulations in the banking, securities, pension and insurance sectors, supervisory capacity in each, and a brief review of accounting issues and payment and settlement systems. Chapter IV summarizes financial intermediation trends and capitalization issues in the banking sector, comparable trends and developments in securities markets (e.g., turnover and capitalization), pension and insurance (e.g., assets, premium revenues). There is also a brief look at some of the costs to the economy over the years of bank restructuring, re-capitalization, and enterprise arrears to a range of creditors. Chapter V provides a brief assessment of risks to financial sector stability and soundness. Chapter VI discusses a range of options on how to contain the risks and help to stimulate additional financial sector development. Chapter VII presents specific recommendations the team believes USAID should contemplate as part of its bilateral assistance to RM in the coming years.

In addition to the chapters, the assessment contains several substantive annexes and data from which the main report is drawn. These include a comprehensive discussion of the banking sector, along with data and tables (Annex 1), a review of banking supervision (Annex 2), a very rough assessment of how the nascent securities markets match up with IOSCO standards (Annex 3), a review of the insurance market and recent pension reform (Annex 4), a list of meetings (Annex 5), and a bibliography (Annex 6).

II. Executive Summary

Primary conclusions by sector.

A. Banking

The banking system remains small, undercapitalized, constrained in terms of lending flows, and unable to modernize from its limited after-tax earnings stream. Continued high levels of non-performing loans have undermined operations. Banks remain risk-averse due to traditional problems with the legal framework, long standing corporate culture, more vigorous enforcement of prudential norms, and the widespread belief that few projects and companies are worth financing under the current incentive structure. Recent strategic foreign investment in several banks should help increase intermediation levels. However, political instability, high unemployment, and the limited range of services offered by banks suggest this will take time. Future assistance should focus on (i) encouraging full exit by Government from banks (including use of Government deposits to influence bank decisions that can distort the marketplace); (ii) professionalizing banking standards, and strengthening corporate governance; (iii) implementing a consistent legal framework for secured transactions; (iv) toughening up on accounting and audit standards (also much needed in the enterprise sector); and (v) developing a comprehensive credit quality database to track arrears and problem credits throughout the economy, not just for bank and Government exposures.

B. Banking Supervision

The overall condition of the Macedonian banking supervision function appears strong. Prudential regulations are comprehensive and broad enough to ensure effective oversight capabilities. The on-site examination function is well-conceived, timely, and staffed with motivated personnel. Off-site capabilities are also strong, given the limited availability of information. On-site and off-site integration and cooperation are advanced and effective. Future assistance should be directed towards the enhancement of regulations, especially in the areas of market risk and money laundering. There is also a pressing need to draft regulations and procedures on the definition and approval of ownership structures of banks, as well as the tracing of funds being invested into the Macedonian banking sector. Specific recommendations are presented in the body of this report.

C. Deposit Insurance Fund

The deposit insurance system in the Republic of Macedonia is unique for an emerging market in that it has been tested and it works. The Fund was well conceived at inception, is well managed, and is well funded. Two areas need to be addressed: (i) current deposit exclusions need to be eliminated, as they are poorly conceived and anti-competitive; and (ii) the Fund's need for additional information. Both of these recommendations are expanded upon in the body of this report

D. Securities Markets

The securities markets are limited in turnover and capitalization. Part of this is due to the privatization method that predominated in the past (MEBOs), leading to the entrenchment of management, accumulation of voting rights, and widespread reports of insider trading. Conversion to IAS is much needed to increase listings on the First Market. More broadly, political stability, regional links, and new investment vehicles are needed to increase interest in listing on the MSE. Future support should focus on (i) changing incentives regarding investment and listing on the First Market; (ii) strengthening SEC capacity by working with IOSCO to enforce basic standards; and (iii) establishing a strategic framework for development of specific forms of securitization (e.g., warehouse receipts, mortgage bonds/mortgage-backed securities) that could serve as a catalyst for intermediary reforms.

E. Insurance

The insurance industry is small, with four companies and annual premium volume of only $84 million in 2000. QBE Macedonia has close to 90 percent of the market. Motor vehicle and property insurance predominate. Virtually no life insurance is sold. The Insurance Supervisory Department is less than two years old and has a staff of only six, yet is competent and committed. A new insurance law is now pending in Parliament. Once enacted, it will provide a comprehensive framework for the regulation of the insurance business, substantially in compliance with EU and IAIS principles. The development of the insurance industry is constrained by poor economic conditions, lack of capacity, lack of trained personnel, and limited confidence in the sector. Yet its development is important as part of the infrastructure needed to support economic growth. Future support should focus on (i) technical and financial assistance, and training; (ii) strengthening the nascent regulatory system to encourage reliable and affordable insurance coverage; and (iii) general efforts to support market development.

F. Pension Reform

The present pension system is an unfunded pay-as-you-go Pillar One system based on mandated contributions of 20 percent of wages. As the number of pensioners increases while the relative number of workers declines, this system will become increasingly difficult to sustain. RM is in the process of developing a complementary Pillar Two system based on individual investment accounts. This defined contribution plan would be funded by contributions of 7 percent of wages and would be mandatory for workers newly entering the labor force. This new system is embodied in a major bill now pending in Parliament. Extensive activity will be necessary to implement the new system, including the creation of pension companies to manage investments and a new pension supervisory agency.

G. Other Financial Services Institutions

Recent success has been achieved from the lending side by one micro-finance institution (Moznosti) that is currently a savings house, and that could evolve into a full-service bank. Such initiatives, and possibly others (e.g., credit unions) should be supported to ensure that small towns, rural communities, and others not targeted by banks have access to fundamental financial services.

III. Acronyms

BSD	Banking Supervision Department
CAR	Capital Adequacy Ratio
DIF	Deposit Insurance Fund
DM	Deutsch mark
EU	European Union
GDP	Gross Domestic Product
GoM	Government of Macedonia
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standards
IOSCO	International Organization of Securities Commissions
ISA	International Standards of Audit
MEBO	Management Employee Buyout
MSE	Macedonian Stock Exchange
MSEC	Macedonian Securities and Exchange Commission
NBG	National Bank of Greece
NBRM	National Bank of the Republic of Macedonia
NGO	Non-Governmental Organization
OTC	Over The Counter (Market)
PAYG	Pay As You Go
PPP	Purchasing Power Parity
QBE	The country's largest insurance company
RM	Republic of Macedonia
RTGS	Real Time Gross Settlement
SOE	State- or Socially-Owned Enterprise
SVP	Small Value Payments
USAID	United States Agency for International Development
ZPP	Former payment system

IV. Background on the Financial Sector of the Republic of Macedonia

A. Early Developments and Recent Trends

Since the build-up of non-performing assets in the banking sector that culminated in the mid-1990s and then resurfaced during the 1999 disruptions related to the crisis in Kosovo, an essential component of the Government's recovery and reform program has been to establish a commercially viable and sustainable banking sector. This has involved legal and regulatory adjustments to bring norms in line with international and EU standards (including an increase in minimum capital), privatization of the Republic of Macedonia's (RM) largest bank, corrective actions implemented in several smaller but troubled banks, liquidation of two additional banks, and a reorganization of the deposit insurance fund for future sustainability.

Developments in 2000-2001 have presented a mixed scenario. In 2000, there were some positive developments, namely continued increases in the household level of deposits and modest increases in lending to both the household and enterprise sectors. However, in 2001, internal political disturbances interfered with the slight restoration of lending activity carried out by banks, and estimates of net credit flow for 2001 are negative. Meanwhile, the conversion to the Euro had a dramatic effect on deposit mobilization, constituting a major increase in deposits and funding for the banking system. It remains to be seen how much of the incremental deposits will remain with the banks, particularly when official unemployment rates remain high, and real GDP growth may be adversely affected by a resumption of political hostilities. The significant increase in deposits suggests that confidence is returning to the banking system, particularly as citizens obtain gradual reimbursement for their frozen accounts from the early 1990s through the redemption of related bonds.

Traditionally, RM's banking sector has been poorly managed, and troubled by high levels of non-performing loans and other assets (on- and off-balance sheet). The ability of banks to demonstrate capacity for sound management will be critical if a large portion of these incremental deposits is to be retained. However, this appears to be a continuous weakness that permeates the banking system. Strategic investors in several institutions do not appear to have made the commitment financially, managerially or operationally that was expected with privatization and sales from 1999 on. The effort to sort out non-performing loans and introduce new systems takes time, and more competitive banks may emerge from this investment at a later date. However, for the moment, these weaknesses combined with general political and market risk has slowed development of a modern banking system. Meanwhile, there has been very little investment through the securities markets, pension reform is still in the preparatory phase, and the insurance sector remains underdeveloped.

The inadequacy of RM's financial sector to date has been a key factor inhibiting the development of the economy. However, such inadequacies cannot be wholly blamed on the financial sector *per se*. Much of the lending was earlier directed by line ministries through banks on political/patronage grounds rather than based on commercial criteria. Financial discipline in the large state/socially-owned enterprise sector (SOEs) was weak at best as governing institutions were able to intervene and encourage the banks to capitalize interest, roll over unserviced loans, provide trade finance facilities (e.g., letters of credit, guarantees) on preferential terms, and offer comparatively easy access to credit on a preferred basis while the SME private sector found it difficult to access credit[1]. By 1999, the losses of the 40 largest SOEs accounted for $95 million in losses, equivalent to about 3 percent of GDP, 43 percent of total enterprise losses, and 86 percent of banking sector loans to these enterprises[2]. As elsewhere in the former Yugoslavia (and transition countries in general), such non-commercial behavior was unsustainable on a macroeconomic basis as well as for structural reasons.

These structural weaknesses triggered the current array of reforms (beginning in 1995 and then reinforced in 1999) to put the financial sector on a commercially sustainable path. Among other measures, this involved a tightening of monetary and fiscal policy to ensure a stable exchange pegged to the DM. In the process, government began to tighten up on its practices of directed lending and other forms of financing. In the process, many enterprises have had difficulty adapting to the new requirements for financial discipline. Faced with reduced access to credit from banks, they have resorted to widespread use of arrears and barter, or have had to rely on "private" financing from informal (unregistered) sources. Among many small enterprises, this has involved "mattress money" or family savings. Among larger enterprises, this has involved unrecorded deals. In the long run, these kinds of approaches are unsustainable for RM to become competitive.

Meanwhile, from the funding side, the 1992 freezing of foreign exchange deposits undermined confidence in banking stability, particularly coming off a history of hyperinflation through the 1980s and early 1990s during the former Yugoslav period. With incomes stagnating or declining, credit access limited, confidence in banks low, and tight fiscal control exercised through giro accounts at the ZPP system, most households and enterprises kept savings/resources outside the system, and conducted transactions privately to bypass the tax authorities. This inevitably created and reinforced macroeconomic weaknesses, as manifested in negative real GDP growth rates through 1995, and anemic real GDP growth until 2000. Inflation rates were hyperinflationary through 1994[3], and did not come down to single-digit levels until 1996. RM suffered deep fiscal deficits through 1993, and weak fiscal revenue flows constrained expenditure for needed infrastructure thereafter. The balance of payments showed very high current account deficits, and hardly any foreign direct investment.

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1 Aggregate figures often show banking sector claims on the private sector to be high. However, in some cases (e.g., IFS), these figures include claims on "socially-owned" enterprises that carried out much of the production activities designed by the government, largely based on directed credits. National Bank figures show lower credit levels in general, and a bit more specificity in terms of the ownership of the enterprises. However, again, many of the private sector companies are, in fact, companies that still operate as they did when socially owned. This has often undercut their efficiency, competitiveness, and credit worthiness.

2 Figures derived from the World Bank. See Report No. P 7395 MK (2nd FESAL), November 17, 2000.

3 RM's peak inflation rate was 1,780 percent in 1992. See "Taking Stock", Finance & Development, September 2000.

Such fundamental weaknesses pointed to a low level of competitiveness, and a high level of dependence on external financing. The table below summarizes some of the macroeconomic weaknesses of the 1990s compared with regional and transition country averages.

Table 1: Comparative Macroeconomic Performance Indicators for RM: 1999-2000

(All in % except FDI)	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Real GDP											
Macedonia, FYR		**-3.2**	**-8.2**	**-1.2**	**-1.8**	**-1.1**	**1.2**	**1.4**	**2.9**	**2.7**	**5.1**
Total CEE and Baltics	-3.7	-11.7	-10.3	-4.8	2.2	6.0	9.2	5.5	3.9	1.2	4.8
Total CEE/Baltics/CIS	-3.0	-9.3	-13.8	-6.6	-4.6	0.9	4.6	4.3	3.3	2.5	5.9
Inflation Rate (CPI annual average)											
Macedonia, FYR		**111.5**	**1511.4**	**352.0**	**126.6**	**16.4**	**2.7**	**1.1**	**0.5**	**-1.3**	**9.2**
Total CEE and Baltics (unweighted average)	202.7	142.1	389.7	125.8	101.6	25.2	25.5	91.5	14.0	8.7	12.5
Total CEE/Baltics/CIS	202.7	142.1	723.4	1066.7	650.9	168.9	81.4	65.6	16.1	26.5	20.0
Fiscal Balance/GDP											
Macedonia, FYR			**-9.8**	**-13.4**	**-2.7**	**-1.0**	**-1.4**	**-0.4**	**-1.8**	**0.0**	**1.0**
Total CEE and Baltics			-7.1	-5.7	-3.2	-3.0	-3.7	-6.5	-3.6	-4.8	-3.3
Total CEE/Baltics/CIS			-11.8	-10.6	-5.2	-4.0	-4.6	-5.6	-4.2	-4.6	-2.9
Current Account Balance/GDP											
Macedonia, FYR						**-5.8**	**-10.3**	**-8.7**	**-9.0**	**-3.2**	**-8.3**
Total CEE and Baltics	-3.2	-4.1	-2.2	-2.0	-2.1	-3.8	-8.2	-8.9	-7.4	-7.1	-6.7
Total CEE/Baltics/CIS	-3.2	-3.1	-0.8	-2.1	-2.9	-4.4	-8.6	-9.3	-10.2	-6.3	-3.5

Table 1: Continued

(All in % except FDI)	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**
External Balance on goods and services											
Macedonia, FYR	**-10.1**	**-2.9**	**1.0**	**-7.9**	**-10.2**	**-9.8**	**-10.3**	**-13.3**	**-14.4**	**-14.2**	
Total CEE and Baltics	-4.2	0.4	-5.2	-5.8	-9.1	-9.0	-11.6	-11.0	-10.8	-9.5	-11.8
Total CEE/Baltics/CIS	-6.0	-1.3	-5.1	-5.1	-8.7	-9.3	-11.0	-12.0	-13.3	-8.7	-6.9
Net Foreign Direct Investment (US$ millions)											
Macedonia, FYR				**0**	**24**	**14**	**11**	**16**	**118**	**30**	**169**
Total CEE and Baltics	300	2,449	3,634	5,580	5,396	12,321	10,416	13,105	17,652	19,517	18,375
Total CEE/Baltics/CIS	300	2,449	3,774	5,803	6,534	16,198	15,559	23,854	24,518	26,134	20,861

Sources: World Bank, IMF, EBRD

B. Recent Developments and Reforms Since 1999

More recently, the Government has initiated reforms that have already restored some of the confidence that was lost earlier in the 1990s. On the legal and regulatory front, the Banking Law was amended to strengthen capital positions, tighten up on loan exposures, and enhance supervisory capacity to preserve financial sector stability and to counter money laundering. This has been accompanied by measures to strengthen creditor rights with tougher bankruptcy legislation, and establishment of central registries for moveable assets pledged as collateral, and immoveable properties that could be used for similar purposes. The privatization of Stopanska Bank to the National Bank of Greece[4] set an effective precedent for strategic foreign investment in the banking sector, and additional new investment has entered from Greek, Slovene and German institutions[5]. A program of corrective action was introduced in eight banks by end 2000 for these banks to fully comply with prudential requirements, including the higher minimum capital requirements that reach

[4] EBRD and IFC are also 10 percent (each) shareholders, along with NBG's 65 percent stake.

[5] Alpha Bank (Greece) acquired shares in Kreditna Bank. Nova Ljubljanska Bank (Slovenia) and LHB Handlesbank (Germany) bought into Tutunska Bank.

Euro 9 million by late 2001 for a full license[6]. The deposit insurance fund was also put on a more sustainable financial foundation with a shift to a premium-based, Government-owned fund. The earlier structure was not feasible in light of the heavy concentration of deposits in two banks, and the impact on the Fund should one or both of the largest banks fail. The Government has also moved forward to modernize the payments system (large and small value), with Real Time Gross Settlement now applied to transactions of 3 million denar or more. Meanwhile, a bank-owned clearinghouse system has recently been introduced for smaller transactions. The Government has introduced a central depositary for shares held and traded on the Macedonian Stock Exchange (MSE). There are plans to launch more open market operations for the implementation of monetary policy, and to put in place a second pillar pension scheme to supplement the current pay-as-you-go system.

More tangibly for households, in 2000, the first interest payments (at 2 percent annualized) were made on the approximately DM 1.1 billion-equivalent in bonds issued to compensate households for frozen foreign currency deposits. This amounted to about $10.5 million-equivalent for households, while their tradability has induced some market activity on the Exchange[7]. Some of these funds were placed in the banking system, as indicated in the substantial increase in deposit mobilization in 2000[8]. However, political instability in 2001 likely reduced some of the funds that might have stayed with the banks, or perhaps traded on the Exchange.

The following table illustrates some fundamental measures of financial sector depth. From the trends, it appears that RM's economy and banking system began strengthening around 1999. This continued into 2000, and year-end 2001 figures particularly highlight the estimated influx of foreign currency deposits. Given the political disturbances of 2001 and the possibility of a resumption of hostilities thereafter, there is no guarantee that these funds will remain with formal institutions. Meanwhile, the political risk associated with RM and the region also bodes poorly for direct investment prospects, notwithstanding increases in 2001. This will continue to constrain financial sector development, and the resource flows needed for the financial system to grow.

6 A "full license" is defined as the right to engage in foreign exchange activities, not just local currency transactions. Legislation permits bank entry into insurance, capital markets and other activities.

7 These bonds approximated DM 1.1 billion, about 2/3 of the original foreign currency value frozen in 1992. There is a two-year grace period on principal. From 2002, principal will be amortized on a semi-annual basis in equal amounts over a 10-year period. Interest payments began in 2000, at 2 percent annualized. Proceeds from the bonds can be used to pay arrears and taxes to Government, and to purchase assets from Government, all at face value. However, on the market, the bonds can and are discounted. Opening trading was at about 58 percent of face value. MSE reports that this has climbed more recently to about 72 percent.

8 The cessation of hostilities in Kosovo provided some basic stability from 1999-2000, although domestic and cross-border skirmishes introduced a new round of instability until mid-2001.

Table 2: Monetary Indicators: 1997-2001

	1997	1998	1999	2000	2001
Broad Money/GDP	13.5%	14.7%	18.7%	20.6%	33.9%
Total Broad Money (denar millions)	24,948	28,045	36,473	44,711	73,579
currency outside banks	7,130	7,136	8,169	9,521	10,354
domestic currency deposits	11,266	13,143	19,184	20,927	18,398
foreign currency deposits	6,552	7,766	9,120	14,263	44,827
Currency Outside Banks/Broad Money	28.6%	25.4%	22.4%	21.3%	14.1%
Broad Money in US$ (millions)	450	541	604	674	1,073
currency outside banks	129	138	135	144	151
domestic currency deposits	203	254	318	316	268
foreign currency deposits	118	150	151	215	654
M1 (denar millions)	13,702	14,952	19,795	22,392	20,400
M2 (denar millions)	11,537	13,573	17,846	23,294	53,179
M1 (US Dollar millions)	247	288	328	338	297
M2 (US Dollar millions)	208	262	296	351	775

Notes: 2001 figures are estimates based on November 31 figures plus December estimates of deposits; NBRM figures differ slightly from IFS

Source: NBRM; IMF; authors' calculations

Despite some encouraging progress, the banking system remains relatively small, with assets at only 39 percent of GDP at end 2000. While this increased to an estimated 52 percent in 2001, the shift is due to the extraordinary deposits attracted in December 2001 in the run-up to the Euro conversion, and in flat GDP (resulting from more than six months of disturbances). Meanwhile, at end 2000, the average bank had only $58 million in assets, $24 million in deposits, and $18 million in capital. By end 2001, banks' balance sheets show an increase in these averages, particularly average deposits ($42 million estimated) and assets ($75 million estimated). However, there is no indication that this has led to an increase in lending, with lending flows down in 2001 after a slight increase in 2000.

Given the fairly large market share of Stopanska and Komercijalna[9], the other 20 banks' averages were small by global standards, with only $10 million in non-Government credit (net of overdues) or securities investment, $26 million in assets (often overvalued or non-performing), $2.8 million in non-bank and non-Government deposits (excludes restricted deposits), and $10 million in capital.

[9] These two banks accounted for 56 percent of credit (to the real sector), 47 percent of assets, and 94 percent of total banks' deposits from households and enterprises at end 2000. However, they only accounted for 20 percent of capital and reserves.

Moreover, bad loans were still high at end 2000, equivalent to about 27 percent of credit, 42 percent of deposits, and 55 percent of net capital. While capital and related figures have not yet been issued for 2001, bad loans remain a concern.

Meanwhile, the earnings stream for banks is still heavily dependent on interest income, and return measures on assets and equity are low despite high real net spreads between loan and deposit rates. Reported after-tax earnings have been practically flat since 1998, averaging $9 million from 1998-2000, or about $400,000 per bank per year[10]. Adjustments to these earnings reports to account for the possible under-provisioning of loan losses suggest the banking system has lost money for years, and that return measures should correspondingly be negative. In any event, even the reported scenario suggests that retained earnings are low, and that the existing earnings stream is insufficient to build capital to levels needed for competitive standards of banking. While 2001 results have not been reported, the odds are strong that earnings have been limited again, partly due to commercial weaknesses and partly due to political factors.

While the banking system is beginning to show signs of intermediation capacity, other aspects of the financial system are underdeveloped. The capital markets are embryonic, with market capitalization at about $6.6 million as of end 2000. This ratio has been consistent since 1997, at about 0.2-0.25 percent of GDP. Turnover increased fivefold in 2000 to about $120 million (i.e., DM 250 million, or about Euro 100 million), mainly the result of privatization transactions sold through the exchange. However, turnover was about half that level in 2001, and 70 percent of volume was in Government securities (i.e., foreign currency account bonds, Government auctions)[11]. By end 2001, the official market only had one active listing and one government bond listed. For some time to come, the markets are expected to primarily serve as a channel for the implementation of monetary policy, and not corporate debt or equities.

Other segments of the financial sector are evolving. The pension system is undergoing reform, with the Law on Capital Financed Pension Insurance comprehensive and drafted, with adoption pending Parliamentary approval and expected in early 2002. This will pave the way for introduction of the second pillar. However, getting the funds up and operating will take time due to the need to develop the implementing regulations, establish the supervisory agency, licensing the funds, and communicating with the public. Even when all of this is done, the high official unemployment rate suggests that financial flows into the funds will take time to be of major significance to the economy. Meanwhile, the insurance sector is limited in capacity, with only four companies operating, one with nearly 90 percent market share. Other forms of financing are limited in terms of penetration. For instance, leasing has not occurred, although there is now preparatory work to activate this sector. Other financing channels exist in the form of savings houses and micro-finance

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10 After-tax earnings were reported to average $9 million each year from 1998-2000. There has been an average of 23 banks during the period. Thus, $9 million/23 = $391,000 in after-tax profits per bank.

11 Turnover in 2001 was Euro 53.2 million. First market bonds (30.3 percent) and Government auctions (40.7 percent) represented most trading activity.

institutions, although these are small in terms of deposits and loans. Mortgage finance is also undeveloped, with very little bank lending for these purposes[12] and an absence of specialized institutions.

While GDP growth rates were originally projected to be 6 percent from 2000-2003[13], this did not occur and negative growth is now the challenge to reverse as RM enters 2002. Even if such 6 percent real growth rates were achievable, RM still remains behind most countries in terms of actual and per capita output. GDP figures at year-end exchange rates for 2000-2001 equated to about $3.3 billion, or about US$1,622 per capita. Broad money approximated $674 million at end 2000, a relatively small base for economic development, although this increased to more than $1 billion by end 2001. Even if a significant portion of that money winds up outside banks, this is likely to stimulate growth and higher real GDP. While purchasing power parity figures show incomes to be at about $5,027 (2000) per capita, or $10 billion-equivalent in total, the economic base is still small. Many households and enterprises have been accustomed to dealing privately and informally to bypass the tax authorities, as shown in the still low tax payments made by enterprises and individuals as a percentage of fiscal revenues[14]. This has deprived formal market structures of many of the resources and incentives needed for further development. Given the major adverse shocks that have occurred in RM since the early 1990s—hyperinflation, frozen foreign currency accounts, embargo by Greece, 1999 refugee influx from Kosovo, and internal disturbances in 2001—RM has managed to achieve a measure of macroeconomic stability and to introduce structural reforms under difficult conditions and trying circumstances. Nonetheless, basic financial indicators show relatively limited development in the banking sector, and even less institutional and market capacity in the securities, insurance and pension markets. Some of the reasons for this situation are discussed below.

12 Tutunska Bank is the only exception, having made about 300 loans in this area.

13 The IMF and GoM projected 6 percent real GDP growth from 2000 to 2003. However, these projections have been radically revised due to political disturbances. Real growth was flat or negative in 2001, and forward projections are more modest (e.g., reported to be 4 percent for 2002).

14 Through November 31, 2001, personal, corporate, wage/salary and "entrepreneurial" taxes were 12 billion denars, or 22 percent of fiscal revenues. By contrast, VAT, excise and customs revenues were 30.5 billion denars, 56 percent of fiscal revenues.

Table 3: A Snapshot of Environmental Challenges in the Financial Sector

Issues	*Challenges*
Banking	
Legal/Judicial	• **Collateral enforcement traditionally weak and still untested, although recently strengthened with tougher legislation and the new registries for pledges and immoveable assets** • **Bankruptcy/liquidation ineffective to date** • **Judicial capacity insufficient, case load backlogged, and traditional role more administrative/bureaucratic** • **New legislation largely untested re market development (e.g., deal-making, corporate governance, shareholder rights)** • **Absence of *formal* and effective extra-judicial mechanisms for dispute resolution** • **Culture of loan default takes time to undo**
Regulatory & Supervisory	• **Banking supervision still lacking in consolidated supervision techniques, anti-money laundering, market risk** • **Coordination of on/site supervision and active policy-making relatively new** • **Risk-based techniques new to RM**
Accounting & Information	• **Limited development of accounting/audit profession and standards** • **Few accountants certified in IAS** • **Tradition of non-disclosure of enterprise sector**
Payment & Settlement	• **Improving with introduction of RTGS, but still some operating problems** • **Clearinghouse system for small value payments burdened by unharmonized software** • **Institutional transition based on transformation of the traditional ZPP system**
Securities Markets	
	• **Increasing liquidity and listings on the First Market** • **Providing adequate financial and related information disclosure to increase investor interest** • **Improving corporate governance at the firm level, including protecting minority shareholder rights**

Table 3: Continued

Issues	*Challenges*
Pension Reform	
	• **Developing supervisory agency and associated enforcement and information flows** • **Establishment of investment vehicles** • **Public education, particularly switch from first to second pillar**
Insurance Sector	
	• **Enhancing supervisory capacity including technical and actuarial skills** • **Promulgating suitable implementing regulations** • **Professionalizing insurance sector and augmenting capacity** • **Diversifying product lines, increasing market penetration, and providing adequate capital to support products**
Mortgage Finance	
	• **New Law recently adopted** • **Financial markets underdeveloped, so little opportunity at the moment to establish special purpose vehicles or to consider any kind of bond issue** • **Municipal finance and administrative capacity inadequate for some of the infrastructure needed for viable mortgage finance markets (e.g., land use management, site planning)**
Leasing	
	• **New Law recently adopted** • **Prudential norms re fixed assets to capital limit banks' ability to acquire premises/equipment for leasing purposes** • **Need for supervisory capacity to monitor for bank-related risks**

V. Institutional Barriers to Reform: Structural Environment Challenges

A. *Banking Sector Development*

1. *The Legal Framework and Banking*

Financial sector development has been slowed for years by a weak legal framework for business credit. As elsewhere in the former Yugoslavia and other transition economies, these weaknesses primarily involved collateral and bankruptcy, both in terms of the law, and with the ability to implement and enforce. The passive, administrative, and politically directed approach to lending served as a catalyst for a strong loan default culture in the financial system, and this continues to burden the portfolio quality of the banks[15]. Meanwhile, because banks were able to access relatively easy financing through the early 1990s, there was rarely any effort to collect on pledges and other forms of collateral. However, as monetary policy tightened around 1995 to bring down inflation rates and budget constraints were imposed to reduce fiscal deficits (1994-95), this put pressure on enterprises to become more disciplined. Instead, enterprises ran up arrears on obligations to banks, other enterprises and utilities, and government (e.g., social insurance, other extra-budgetary accounts) to contend with a tightening of monetary and fiscal policy. This left many banks with non-performing loan portfolios, a problem that ultimately culminated in 1999 with major losses at Stopanska and other banks. With the introduction of new prudential norms, banks are now required to comply with NBRM requirements. This, in turn, leaves banks with little option on the credit side unless they have the tools needed to be able to collect on their loans.

Recognizing this as a serious weakness and constraint to intermediation, creditor rights were strengthened with adoption of the new Law on Bankruptcy. The Law was drafted in an effort to rectify loan portfolio problems faced by the banks, to instill a measure of financial discipline into the enterprises, and to provide the banks with more of an incentive to lend on commercially viable terms. Evidence from 2000 suggests that this trend was beginning to occur, although banks still have high levels of classified loans on their books. More recently, in 2001, lending flows reversed due to political uncertainty.

Notwithstanding the new Law, there is still a general weakness in the legal system in terms of judicial capacity. Limitations of the courts in terms of capacity have limited the ability to adjudicate disputes in a timely manner, or to enforce once judgment has been rendered. Judges have been trained to carry out many administrative and bureaucratic functions (e.g., company registration), and their training has not been at advanced levels. Commercial training is limited, as is experience. Pay has been relatively low, which has reportedly invited favoritism and, in some cases, corruption. Support staff is likewise not paid well, reducing efficiency and adding to potential issues of

[15] As of mid-2000, classified loans were 39.1 percent of total credit exposure. This figure peaked in September 1999 at 44.8 percent, mostly the result of banks' exposure to loss-making SOEs. Doubtful and loss loans were 24 percent at June 30, 2000.

corruption. Much of the processing is manual, indicating that systems and infrastructure are underdeveloped. Previous provisions in the earlier Law provided debtors with opportunities to stall under the guise of recourse. More broadly, the drafting of legislation is considered to be poor and ambiguous, leaving judges with enormous discretion and without guarantees of consistency in treatment.

Recent legislation seeks to reduce stalling opportunities, and to provide greater clarity in terms of creditors' rights. However, as this is a new development in an economy lacking a commercial law tradition, this will take time to institutionalize. Movement to support creditors' rights should reduce their risk aversion with regard to lending exposure. However, until there are clear precedents for timely collection on past due loans, it is likely to take time before banks are willing to lend on much more than a short-term basis. If so, this will also make it difficult to stimulate project finance, leasing, mortgage lending and other kinds of term finance markets needed for broader development.

2. *The Prudential Regulatory Framework and Banking Supervision*

The prudential regulatory framework has been strengthened in recent years, particularly with regard to minimum capital requirements, and exposures to single parties. Throughout most of the 1990s, banks had recurrent problems on the asset side rooted in poor loan quality, and this undermined solvency. Prudential regulations have been strengthened in recent years for RM to stabilize and privately recapitalize its banking system, provide stricter guidelines and requirements to ensure adequate liquidity and solvency, and to more generally conform with international and EU standards[16]. Broad prudential requirements adhere to Basle Committee recommendations and EU norms.

NBRM has been gradually asserting its supervisory mandate in an effort to promote financial sector stability. For instance, in the case of capital adequacy, RM has tightened up on the criteria and risk weights used to achieve a minimum 8 percent for regulatory compliance. In the past, banks reported figures that were well above these minimum requirements, yet they were frequently insolvent. Since 1999, NBRM has required stricter provisioning for loan losses, and tightened up on banks' practices of rolling over loans, capitalizing interest, and related practices used to cover up hidden losses and overvalued assets. Consequently, banks' net provisions for loan losses have increased substantially since 1999 in comparison with earlier years. Another example has been the corrective action plans that have been introduced for eight troubled banks, and corrective actions introduced at more banks in 2000. All banks are expected to be fully compliant with regulations. Enforcement measures have been taken in some cases in tandem with forbearance permitted during this period to allow smaller banks to achieve capital and other requirements. However, when necessary, NBRM has also liquidated banks[17]. In other cases, consolidation has occurred in a manner not all together different

[16] RM entered negotiations for membership in the WTO in July 2000. Likewise, negotiations with the European Union on a Stabilization and Association Agreement began in April 2000.

[17] Examples include Almako and Akabanka, along with one savings house.

from a purchase and assumption transaction[18]. Particularly since the financial condition of the earlier (pre-privatized) Stopanska Bank deteriorated and adversely affected the economy as a whole[19], NBRM has been willing to impose lending limits, remove management, and threaten banks with downgrading or withdrawal of a license. Criminal charges have been filed on occasion as well[20].

The Banking Supervision Department (BSD) of NBRM is considered reasonably strong, notwithstanding some areas of needed additional assistance (e.g., consolidated supervision, market risk analysis, broad parameters of risk management, money laundering). BSD has developed fundamental capacity to conduct off-site surveillance, on-site inspection, and policy coordination. Most off-site analysts have on-site inspection experience. A new early warning system has been put in place. Regular reports are now required for liquidity and solvency monitoring as well as for a range of exposures (e.g., foreign currency, credit concentration).

Meanwhile, with introduction of a new deposit insurance scheme[21], it will be essential that banking supervision is effective in identifying and containing risks in the market, that appropriate incentives are in place for banks to properly manage their risks in support of general financial sector stability, and that appropriate communications channels are in place should unexpected risks emerge. This will require that NBRM be able to certify that banks' internal systems are appropriate. With foreign investment in Stopanska, Tutunska and Kreditna plus the strong reputation for systems enjoyed by Komercijalna, the larger banks' systems are expected to become more complex in the coming years. NBRM will need to understand the workings of these systems to validate their compliance with regulatory requirements. As the deposit insurance fund does <u>not</u> have a supervisory or resolution function, it is wholly dependent on NBRM to ensure the banks are sound and stable. Now that the banks are beginning to show higher deposit levels, it will be essential for NBRM to reinforce these trends for sustained public confidence in the banking system. A call on deposit insurance funds or depletion of those funds would likely reverse the confidence that has slowly begun to return to the system.

In general, the overall condition of the RM banking supervision function is strong. Given the relatively short development period, prudential regulations are comprehensive and broad enough to ensure effective oversight capabilities. The on-site examination function is well conceived, timely, and staffed with motivated personnel. Off-site capabilities are also strong, given the limited

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18 For instance, some smaller banks have been merged and consolidated.

19 The Government had to cover DM 235 million in bad loans as a precondition of the NBG privatization moving forward. NBG plus the other buyers paid about DM 60 million for the bank, and agreed to inject an additional DM 50 million to shore up liquidity. At a minimum, the net cost was equivalent to DM 125 million, or about 2 percent of 1999 GDP. However, losses, inability to meet reserve requirements, and other problems at Stopanska indicate that the cost to the economy exceeded net DM 125 million.

20 See "Annual Report: 2000", National Bank of the Republic of Macedonia, March 2001.

21 RM had a Savings Deposit Insurance Fund that was introduced in January 1997 and originally capitalized by the banks. However, because the banks themselves were in troubled financial condition, the arrangement was not sustainable. This arrangement was subsequently replaced in November 2000 with a new Deposit Insurance Fund that is state-owned.

availability of information. CAEL[22] scoring models are in use, and off-site data are incorporated into the examination planning process.

On-site and off-site integration and cooperation are surprisingly advanced and effective. Much of this success can be traced to the decision to establish an independent off-site unit that focuses on purely quantitative analysis, but that is staffed with analysts that were formerly senior on-site inspectors. This decision has led to an atmosphere of cooperation and respect between the units, while maintaining the distinction between on-site work and the off-site analysis process.

Notwithstanding these strengths, there are gaps and weaknesses that should attract future assistance. This should be directed towards the enhancement of regulations, especially in the areas of market risk and money laundering. There is also a pressing need to draft regulations and procedures on the definition and approval of ownership structures, as well as the tracing of funds being invested into the RM banking sector. The following are the most pressing issues presently facing the system and are the areas in need of more immediate assistance:

- The Supervision Department is in immediate need of short-term legal consultation on how to amend existing regulations concerning regulatory approval of ownership structures. Article 11 of the NBRM Banking Act states that *"for gradual or one-time acquisition of shares, regardless of whether they are acquired by one or more affiliated persons, whose total cumulative nominal value is 10%, 20%, 33%, 50% and 5% of the total shares with managing right, prior approval must be granted by the National Bank."* As written and enforced, individuals or entities that acquire 9.99 percent of the voting shares are not required to obtain prior approval from the NBRM. The Law is also ambiguous in its definition of related entities. These factors, combined with the NBRM's limited abilities to investigate domestic and foreign investors, and to trace the source of the invested funds, has led to severe concerns about bank ownership structures. This area is directly related to domestic and donor agency desires to increase NBRM surveillance capacity regarding money laundering. Based on these weaknesses, there is a strong need for donor assistance in reviewing and drafting regulations in these areas. This assistance should be short-term in nature (3-6 months), and should work directly with the BSD legal, enforcement and on-site supervision units.

- There is a need for short-term technical assistance in the drafting and implementation of consolidated supervision methodology as required under Basle Core Principles 21, 23 and 24. Ideally, such assistance should be given after the restructuring of legal requirements, as this would be a prerequisite for this type of assistance. Assistance should be focused on training on consolidated supervision methodology, including the analytical techniques used to evaluate the financial capacity and condition of banking groups and related organizations. Training should also be given on cross-border analysis.

[22] Capital, Asset quality, Earnings and Liquidity.

- In conjunction with the above, there is also a need for a much higher level of training concerning Country Risk (Core Principle 11), Market Risk (Core Principle 12) and Operational Risk (Core Principle 13). Donor assistance is needed primarily in training, again assuming that the legal assistance has been completed. Based on conversations with Supervision staff, the greatest area of uncertainty, and the area that needs to be addressed to implement the new "S" component in the CAMELS[23] rating system, is the concept of market risk. Given the embryonic nature of RM's capital market structure, there is little understanding as to potential risks other than exchange rate risk. However, increased foreign investment, and the development of domestic capital market instruments will eventually change this environment. Again, assistance in this area should be short-term in nature and focused on formal training.

Most of the above gaps can be bridged with short-term training. It is important to emphasize the need for domestically relevant training. Standard Basle Principle courses, while somewhat effective, will not be as effective as training materials based on the unique characteristics of the local RM market. There are factors in the market that make standard or template training ineffective, and would likely be poorly received. Thus, technical assistance should be focused on advisors either that have resided in RM before, or who will live in RM on a short-term basis during the entire development of the training materials. That would ensure that the materials prepared are based on local realities and practical.

3. *Accounting, Statistics and Information*

Generating reliable, accurate and timely information has been a longstanding weakness in the financial sector, and even more problematic in the enterprise sector. While IAS has been mandated since 1997 for banks, there is limited domestic capacity. At the same time, given the small number of large firms and only one actively traded firm on the First Market of Exchange, there is only a small market to date for auditing firms. Conversion to IAS represents an immediate need for many companies, and as a prerequisite for expanding the number of companies listed on the First Market of the MSE. However, there are larger issues as well that will take time and assistance to develop. This includes the need for professionalization and certification standards, increasing the number of accountants and financial managers versed in IAS, and having some form of professional association to help upgrade the overall quality of accounting standards and practices in RM.

Currently, there are problems associated with the timeliness and quality of macroeconomic data. As the economic system becomes more market-based, market players will want and need more and better information. This is not only true of lenders, but also of investors as RM moves to create a more viable securities market in the coming years. On this note, such information will not only be necessary for stock exchange development. It will also be essential in the long run if RM wants to foster an environment in which institutional investors can play a role. The move to a second pillar pension scheme that is publicly mandatory and privately managed indicates this is the direction RM is taking. Absent adequate and timely information, institutional investors (e.g., insurance companies,

[23] Capital, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk.

pension funds) will likely put their investment resources into lower return Government securities, or abroad for safety. This would represent a missed opportunity in a country that needs to capitalize on every possible opportunity available for market development and expansion. Conversely, the absence of such information will place limits on overall market development, and will serve as a constraint to development of the financial services industry.

As noted, most of the deficiencies in information are attributed to the real sector. Business accounting practices are particularly weak in the enterprise sector, and this reduces the willingness of banks to lend. This is typical in the region, as accounting standards and regulation are generally stricter on deposit-taking institutions and official market listed firms than they are on most real sector firms. Moreover, accounting has generally been a tax-oriented function in the enterprise sector, rather than a business management function or tool. Until the market develops, this is unlikely to change any time soon. At the same time, this is a vicious cycle, as markets trade on reliable information. Absent needed information, markets will not develop. The absence of viable banking and capital markets reduces the incentive of businesses to produce meaningful financial statements and to generate regular information for financing purposes. On the other hand, bankers and investors often cannot submit themselves willingly to risk exposures when they do not have adequate financial statements and notes to work with. Better information will eventually be required to increase the willingness of banks and investors to assume greater risk.

On a more positive note, information from banks is improving with more regular reporting requirements for prudential compliance, and increasing preparation for the use of risk-based indicators for decision-making. RM and NBRM are also committed to improving the quality of statistics and information, as well as the disclosure of that information. This will ultimately help in developing market-based institutions. However, implementation has been slowed by the absence of experience, expertise and standards. Near-term conversions of companies to IAS will help increase the potential pool of firms that could list on the First Market of the MSE. Meanwhile, full movement to IAS and ISA will require several years of professional training and development.

4. *Payments and Settlement*

RM has made progress in the last two years in moving towards a more modern payment and settlement system. The traditional system was run through ZPP, which undermined use of the banking system for transactions. This was because of the tax control function of the ZPP, and its ability to immediately block giro accounts when delinquencies occurred. However, the ZPP system is being transformed, and has now been replaced with a system that relies on the banks to clear and settle small value transactions under 3 million denars (less than $45,000), and a Real Time Gross Settlement System for larger transactions.

While there has been progress, a number of problems appear to burden the transformation. The RTGS system has apparently faced some operational difficulties. These are manageable, yet they surfaced at a time (mid-December, 2001) when Macedonian citizens were coming to banks with DM and other currencies to convert to Euros. Meanwhile, the clearinghouse system is reported to be having problems because NBRM and each of the banks have used in-house staff to develop software for clearing and settlement purposes. This has led to problems of systems interface, slowing the process and possibly committing errors. Furthermore, most banks themselves remain manual in many of their processes, and insufficiently specialized. This perpetuates a long tradition of poor customer service, adding to processing time. Links to the securities markets through the Central Depository appear to have gone fairly smoothly, and there have been fewer problems reported with new share registry system.

B. Securities Market Development

The primary function of free capital markets is the ability to lend to liquidity-constrained, yet credit worthy, borrowers at interest rates that reflect true credit risk. Borrowers generally act more responsibly with funds borrowed from private creditors than with funds borrowed or placed by domestic governments or donor agencies. Borrowers that default on private loans are often excluded from private capital markets for a decade or more. Market discipline constrains reckless behavior. While RM is making progress in its development of functioning capital markets, there are legal, social and political obstacles that remain.

The Macedonian Stock Exchange currently has two listed companies on the First Market, and only one is actively traded. There is strong reluctance by companies to list, as this would disrupt ownership structures. Currently, the MSE (especially the Third Market) is being used by various parties to change controlling interests in various companies. Individual shareholders are discouraged by management from selling their shares, and most shareholders have given up their voting rights to management.

All of this has translated into slow development of securities markets in RM. Part of this relates to the frequent shocks that have occurred in recent years. Other weaknesses include weak standards of corporate governance, insider manipulation by managers and related parties, non-transparency of most trading (on the Third Market of the Exchange), and general lack of confidence of the public in many financial institutions.

As for regulation, there are two components. The MSE is a self-regulating organization. However, the Securities and Exchange Commission is legally empowered to regulate and supervise. The Securities and Exchange Commission of RM (MSEC) was established in 1992. The MSEC is an autonomous and independent legal entity with responsibility for regulating and supervising the Macedonia securities market. The MSEC is in charge of implementation of the Securities Law and the Investment Fund Law, as well as all other regulations based on these two laws. From this legal mandate, the Securities and Exchange Commission[24] is empowered to (i) pass acts or rules and issue approvals; (ii) undertake measures to protect the interests of shareholders and investors, and to prevent dishonest and illegal activities related to trading in securities; (iii) regulate the method of securities trading the MSE; (iv) monitors and control the activities of brokerage houses and banks in

24 See www.sec.gov.mk.

their dealings with securities, as well as authorized investment management companies (i.e., investment funds); (v) conduct inspections of the operations of the Central Depository for Securities; (vi) inspect and prescribe standards of competition among brokerage houses and banks in their dealings with securities, as well as authorized investment management companies (i.e., investment funds); (vii) grant approvals for the appointment or release of managers covered under the two aforementioned laws; (viii) approve public invitations for the public offer of securities; (ix) ensure a legal, fair and transparent securities market; (x) approve the rules of the securities market related to the listing of securities, and the obligations for disclosure and periodic financial statements of listed companies; (xi) cooperate with other institutions in and out of RM by exchanging information and other means; (xii) pass acts or rules for the internal organization of the Commission; and (xiii) perform other activities related to the operation of the securities market in accordance with the Law.

Notwithstanding the powers enumerated above, there has been only partial compliance to date with most IOSCO standards (see table below). More significantly, the securities market in RM has been limited in terms of providing financing instruments for companies. Trends were favorable in 2000, the last stable year. However, more than 70 percent of turnover is Government securities (auctions) and bonds, and there is only one listed company that is actively traded on the First Market. For some time to come, the markets are expected to primarily serve as a channel for the implementation of monetary policy, and not corporate debt or equities. This could change as larger companies convert to IAS. However, no major changes in listings are expected for at least one to two years, and this is subject to political stability, the macroeconomic framework, and related issues.

Table 4: Informal Assessment of Securities Market Practices re: IOSCO Standards

Principles	**Practice**	**FO [1/]**	**BO [2/]**	**NO [3/]**
Principles Relating to the Regulator (1–5)	The Macedonia Securities and Exchange Commission (MSEC) is independent and has adequate powers and resources to be effective. However, laws are being rewritten and amended to make them more applicable to the domestic environment. There is a very great need to have integrated legal reform in this country, as changes in some areas are not being discussed with affected parties.		X	
Principles of Self-Regulation (6–7)	Process not in place, but framework is under development.			X
Principles for Enforcement of Securities Regulation (8–10)	The MSEC has adequate enforcement power as it is permitted to revoke licenses. These powers are not very well known in the industry and have not been tested.		X	
Principles for Cooperation in Regulation (11–13)	Not observed during assessment.			X
Principles for Issuers (14–16)	This is reported to be an area of serious weakness in the system.			X
Principles for Collective Investment Schemes (17–20)	The Law on Investment Funds is broadly written and allows for the development of open-end funds, closed-end funds and unit trusts.		X	
Principles for Market Intermediaries (21–24)	The Law on Securities, including recent amendments, provides the legal basis for market intermediaries. These are with EU requirements.		X	
Principles for the Secondary Market (25–30)	While the Central Depository is in place, there are many problems in ensuring that accurate shareholder records are submitted. In addition, legal precedent is unavailable on this issue. Other areas were compliant with standards		X	

Notes: 1/ FO: Fully observed; 2/ BO: Broadly observed; 3/ NO: Not observed.

Source: authors' assessment

C. *The Legal Framework for Pension Reform*

New legislation addressing pension reform has been introduced in reaction to the realization that the current Pillar One system is unsustainable over time. (See page 54 for an explanation of both the Pillar One and proposed Pillar Two pension system.) The barriers impeding continued successful implementation of the current system relate principally to an inadequate number of active workers contributing to a system featuring a growing number of retirees. This has been compounded by a lack of reserves in the system, and the vicissitudes of the economic cycle, especially high unemployment, which affect the overall level of contributions.

The new legislation is intended to overcome these barriers, but they raise other possible impediments in the short and medium term. Some of these are institutional in nature, as investment vehicles must be dentified and/or created. Furthermore, the administrative apparatus must be established. There are educational issues as well, as participants must be convinced of the wisdom and need for the new Pillar Two system, and training must be provided to those responsible for administering the new system.

D. *Insurance Sector Development*

1. *Legal Framework for Insurance*

The pending insurance law, comprised of 252 articles, contains detailed, sound provisions in most areas of concern in the regulation of the business of insurance. As set forth in greater detail in Annex 4, the draft law includes effective provisions relating to capitalization, licensing, foreign insurers, solvency margins, investments, reserves, internal audit, financial reporting and examination, licensing of brokers, certification of actuaries, supervision, insolvency, and enforcement. It appears to substantially comply with European Union standards, and with the Core Principles of the International Association of Insurance Supervisors.

Articles 1 through 11, General Provisions (Section 1), specify the reach of the law, the types of insurance undertakings that are subject to it, and definitions of the various classes of insurance. This section includes the application of the law to foreign as well as domestic insurance undertakings. Chapter 1 of Section 2 sets forth the standards for incorporation of insurance undertakings. As well as referencing the minimum capital standards set forth later in the law; the law (Article 16) limits the holdings of any individual stockholder to no more than 25 percent of the shares of the insurer. This chapter also sets forth limitations for the acquisition of shares of an insurer by a third party. In addition, it sets forth requirements for the functioning of the managing body of the insurer and of its supervisory body.

Section 3 of the law governs the incorporation and operation of the insurance undertaking. The first requirement specified is licensure. Application procedures as well as documentary requirements are included. This section also includes detailed provisions governing the issuance of the decision to grant or deny a license. Procedures are also set forth as to the licensing of outsourcing activities and transfer of insurance portfolios to other insurers.

Chapter 3 of the law governs the performance of insurance activities outside of RM. The law distinguishes between activities in a member country and a foreign country. To conduct operations in a member country, the insurance undertaking must give prior notice to the Ministry of Finance concerning the insurance activities to be conducted and, if applicable, the address and responsible persons at a branch office to be located there. The Ministry of Finance shall supervise the operations of the Macedonian insurer in the member country or request the relevant supervisory body of the member country to do so, and that body shall be informed in any event. To conduct operations in a foreign country, the Macedonian insurer must obtain a license and establish a branch office.

Chapter 4 provides that insurers from member countries may conduct operations in RM, either directly or through a branch office, on notification to the Ministry of Finance. Although the supervisory body of the member country shall continue to supervise the activities of the insurer in Macedonia, the Ministry of Finance shall have authority to impose a ban on the issuance of new insurance policies.

Chapter 5 provides that foreign insurers may conduct operations in RM only through branch offices and with a license from the Ministry of Finance. Requirements include posting a deposit in a separate account to cover liabilities arising from policies covering Macedonian exposures, and complying with a detailed list of requirements (although the law exempts Swiss insurers from some of them).

Section 4 of the new law, captioned "Risk Management", governs capital requirements for insurers. It provides for the inclusion of certain types of capital, such as paid-up shares and retained earnings, but excludes others, such as stocks owned by the insurer and long-term intangible assets, from basic capital. Insurers are required to set aside in a safety provision one third of profits until the safety provision equals one half of the average premiums collected over the preceding two years. The chapter also limits the proportion of assets that may be invested in certain asset classes, such as real estate, stocks, and bonds.

Articles 75 and 76 set forth detailed formulas for the calculation of solvency margins for both life and non-life carriers. Article 77 sets forth minimum "guarantee fund" amounts varying with the classes of insurance issued that the insurer must maintain. The following articles include requirements for establishing reserves with respect to both unearned premiums and claims, whether or not yet reported to the insurer, including actuarial provisions. Chapter 4, beginning at Article 86, requires insurers to maintain assets at levels sufficient to cover required reserves. It includes general requirements as to diversification and management of investment risk, and it enumerates fifteen classes of permitted investments. It also prescribes limitations in the percentage of assets that may be invested in certain asset classes, and it proscribes certain asset classes altogether. Chapter 5 includes additional rules applicable to assets set aside to meet so-called "mathematical provisions".

Chapter 6 sets forth rules governing reinsurance carried by Macedonian insurers, including the determination of maximum permitted retention. It sets standards for maintenance of liquidity, adherence to statistical standards, quarterly monitoring of capital, solvency margin, reserves, asset valuation, and investments. This chapter includes prohibitions against dividend payments under specified circumstances, and requires management to maintain adequate solvency margins and report actions taken to the Ministry of Finance. Section 5 requires insurers to maintain personal data on a confidential basis, with certain limited specified exceptions. Article 109 sets forth types of data that insurers must maintain in organized databases.

Articles 110-116 set forth provisions relating to certified actuaries and the tasks that they are to perform. They include standards for certification, a requirement that licensed insurers appoint a certified actuary, prohibitions against conflicts of interest, and requirements for actuarial certification of the insurer's annual accounts, including calculation of premiums and adequacy of reserves.

Section 7, beginning at Article 117, requires insurers to maintain detailed books of account in conformance with applicable requirements. It requires insurers to submit annual reports to the Ministry of Finance certified by both an actuary and an auditor. Each insurer is also required to maintain an independent internal audit unit reporting directly to the managing board of the company. This unit is required to perform a complete supervision of the company's operations to verify that it is conducting its operations in compliance with the law. This section includes detailed provisions as to the procedures to be followed by this unit and the contents of its reports, which must be made twice each year, as well as reporting procedures (including to the Ministry of Finance if breaches of the risk management rules or threats of insolvency are found).

Section 10 of the law governs agents and brokers. Agents need not be licensed, but the law (Article 134) states directly that an insurance undertaking shall be held liable for the activities of an insurance agent. Chapter 2 of this section, however, includes detailed procedures and standards for the licensing of insurance brokers. Included are disclosure requirements as to potential "clashes of interest", commission limitations, licensing requirements, and supervision requirements by the Ministry of Finance.

Section 11 of the law sets forth the basis for supervision of insurance undertakings by the Ministry of Finance. The duties include off-site supervision by collecting and analyzing data and reports. In addition, the Ministry has the authority to direct insurers to eliminate violations and to withdraw licenses and order liquidation of insurance undertakings. The law also sets forth procedures in the event of bankruptcy, including the degree of applicability of the Bankruptcy Law and priorities of claims. The law includes special provisions relating to claims for payments relating to assets covering mathematical reserves and the appointment of curators. The law also includes provisions relating to discontinuance of unlicensed insurance undertakings.

Section 12 of the law provides for procedures for issuing decisions by the Ministry of Finance. These procedural provisions include on-site supervision procedures and processes for eliminating violations of the law, including filing objections. Also included are procedures for the issuance of decisions and revocation of licenses.

Section 13 of the law governs insurance and reinsurance pools. It directs and sanctions the formation of the National Association of Insurers. Section 14 sets forth the permitted activities of the association, including the establishment of a guarantee fund.

Section 15 sets forth procedures for cooperation by the Ministry of Finance with other supervisory bodies within the European Union. These provisions include the responsibility of the Ministry of Finance to inform other supervisory bodies of any significant obstacles faced by the insurance undertaking active in foreign countries, as well as the responsibility of the Ministry to respond to requests made by European supervisory bodies.

Section 16 of the law provides for penal provisions. For 18 major violations, fines of 250 to 300 million denars are established. Fines of 45 to 50 million denars are also authorized for individuals within an insurance company who are responsible for any of the enumerated offenses. Fines are also authorized for members of the managing or supervisory boards of an insurance company. In addition, brokers, auditors, and actuaries are subject to fine as well.

Section 17 of the law sets forth transitional provisions. A six-month period from enactment is provided for existing insurers to come into compliance with the law.

Table 5: A Summary of RM's Legal and Regulatory Status re: IAIS Standards

Standards	**IAIS Standard**	**Status in RM**
Effective Insurance Supervision	Requires preconditions to be in place, largely beyond the control of the supervisory authority. Weaknesses or shortcomings in these areas may significantly impair the ability of the supervisory authority to implement the Core Principles effectively. The preconditions cover a range of areas, including (i) well-developed public infrastructure; (ii) procedures for the efficient resolution of problems in insurance companies; (iii) effective market discipline; and (iv) sound and sustainable macroeconomic policies. Public infrastructure may have a profound effect on a jurisdiction's ability to implement the insurance Core Principles. The legal system is the foundation of the financial system, which ensures the honoring and enforcement of insurance contracts. An adequate infrastructure also requires that accounting standards be comprehensive, internally consistent and approach international best practices, so that investors and supervisors can properly evaluate the financial conditions of the insurance companies, and the insurance companies can assess the health of the institutions that they lend to or invest in. The development of insurance products and sound financial management, in particular the calculation of technical provisions (policy liabilities), requires a strong actuarial profession. Accurate financial data requires qualified experts, including accountants, auditors and financial analysts. Other key considerations in evaluating the public infrastructure are the effectiveness of supervision in other financial sectors and markets, as well as the risks inherent in the payment system.	These preconditions go beyond the content of the Macedonian law. Current weak economic conditions, ethnic tensions and recent hostilities, unreliable courts, limited public confidence in financial institutions, and a highly concentrated but small insurance industry indicate that these preconditions are not fully present in RM.

Table 5: Continued

Standards	**IAIS Standard**	**Status in RM**
Consumer Protection	An insurance supervisor is expected primarily to protect policyholders by ensuring that companies comply with the legislation and regulations governing the business of insurance, and to maintain efficient, fair, safe and stable insurance markets for the benefit and protection of policyholders.	The Insurance Supervision Department is small, with six professionals on staff. It is only a year and a half old. While the present Head of Department and her staff are highly competent and motivated, they have limited resources to discharge substantial obligations. The new law provides detailed and thorough provisions intended to assure the safe and constructive operation of the insurance industry, but it will require significant resources to enforce.
Operational Independence	The insurance supervisor should be operationally independent and accountable in the exercising of its functions and powers; have adequate powers, legal protection and financial resources to perform its functions and exercise its powers; clearly define the responsibility for decision making; and hire, train and maintain staff with high professional standards who also follow the appropriate standards of confidentiality. The insurance supervisor is operationally independent from both political authorities and the insurance companies that it supervises in the execution of its supervisory tasks, and is accountable in the exercise of its functions and powers.	The Insurance Supervision Department appears to be independent of the insurance industry that it regulates. The new law gives it adequate powers and specific standards to apply, but it is not clear that it has adequate resources to carry out its mandate.

Table 5: Continued		
Standards	**IAIS Standard**	**Status in RM**
Remedial Action and License Revocation	The insurance supervisor had adequate powers, legal protection and proper resources and staff, and the capacity to perform its functions and its powers. Insurance supervisors must have the power to take remedial action where problems involving licensed companies are identified. The insurance supervisor has the right to withdraw the license on grounds of substantial irregularities (e.g. if the company no longer meets the licensing requirements, or seriously infringes the law in force). Insurance supervisors must have the power to take remedial action where problems involving licensed companies are identified. The supervisor must have a range of actions available to apply appropriate sanctions to problems encountered. The insurance supervisor ensures that remedial actions are taken in a timely manner.	The new law grants the supervisor the authority to take remedial action and to withdraw an insurer's license where warranted. (Section 11; Section 12, Chapter 2.) What is uncertain is whether the supervisor will have adequate resources to fully carry out the mandates of the new law. Section 12 includes authority for the Ministry of Finance to issue orders to eliminate violations. It also includes authority to revoke an insurer's license. Detailed procedures for such actions are included in the law.
Supervisory Process	Adopt a clear, transparent and consistent regulatory and supervisory process. The responsibilities of the insurance supervisor are clear and objectively stated. The insurance supervisor adopts a clear, transparent and consistent regulatory and supervisory process. The rules and procedures of the insurance supervisor are published and updated regularly.	The new law is unusually clear and transparent as to both its substantive standards and its procedures. It clearly states the responsibilities of the insurance supervisor. It provides for the issuance of implementing regulations. (Sections 11 and 12.)

Table 5: Continued

Standards	**IAIS Standard**	**Status in RM**
Audits and Examinations	A process should be established for ensuring that external audits of insurance companies operating in the jurisdiction are acceptable. If its own capacities are not sufficient, the insurance supervisor should be able to outsource to third parties (e.g. auditors, actuaries) supervisory tasks such as on-site inspections and monitoring in the solvency position or the sufficiency of technical provisions (policy liabilities). The insurance supervisor requires that information is verified periodically through on-site examinations conducted by himself, external auditors or other qualified parties. The insurance supervisor has the authority to require insurers to hire, using their own resources, independent auditors or actuaries for auditing or reviewing all or specific items of financial statements whenever the insurance supervisor has doubts as to their accuracy.	The new law provides for external audits of insurers and authorizes outsourcing to auditors and actuaries, who are given substantial roles under the law. The law authorizes on-site examinations. The law requires insurers to use auditors and actuaries at their own expense to certify their financial statements. (Sections 9, 11, and 12.)
Licensing	Companies wishing to underwrite insurance in the domestic insurance market should be licensed. Where the insurance supervisor has authority to grant a license, the supervisor in granting a license, should assess the suitability of owners, directors, and/or senior management, and the soundness of the business plan, which could include pro-forma financial statements, a capital plan and projected solvency margins. Legal provisions on licensing are in place through the insurance law. These legal provisions define the types of company or entity that are insurance companies or entities, and the insurers which must be licensed or define insurance business, and prescribe that all of entities writing insurance business must be licensed. A company licensed to operate life insurance should not also be licensed to operate non-life insurance and vice versa, unless there are clear provisions, which the insurance supervisor finds satisfactory, requiring that risks be handled separately on both a going concern and a winding-up basis.	The new law provides detailed and specific provisions for licensing of insurers. Non-licensed insurers are not permitted to operate in RM. The law does not require separate companies for life and non-life insurance. This condition most likely reflects the fact that QBE Insurance, the only Macedonian insurer that writes life insurance, is both long-standing and writes only a miniscule amount of life insurance. (Section 3.)

Table 5: Continued

Standards	**IAIS Standard**	**Status in RM**
Change in Control of Companies	The insurance supervisor should review changes in the control of companies that are licensed in the jurisdiction. The insurance supervisor should establish clear requirements to be met when a change in control occurs. These may be the same as, or similar to, the requirements which apply in granting a license. In particular, the insurance supervisor should require the purchaser or the licensed insurance company to provide notification of the change in control and/or seek approval of the proposed change; and establish criteria to assess the appropriateness of the change, which should include the assessment of the suitability of the new owners as well as any new directors and senior managers, and the soundness of any new business plan. The law defines such changes and permits the insurance supervisor to take into account the substance as well as the form of the transaction. The insurance supervisor has the authority to refuse or revoke a license if the organizational (or group) structure of the applicant or licensee hinders the effective supervision.	The law includes provisions applicable to the transfer of insurance portfolios. (Section 3, Articles 42-44.)
Fitness and Propriety	The supervisor in granting a license should assess the suitability of owners, directors, and/or senior management. Legal provisions exist on whether key functionaries such as owners, directors and/or senior managers are fit and proper (i.e., possessing the necessary knowledge, skills and integrity of their positions). The insurance supervisor should establish criteria to assess the appropriateness of the change, which should include the assessment of the suitability of the new owners as well as any new directors and senior manager. The insurance supervisor requires that insurance entities (insurers and intermediaries) have key functionaries who are and remain fit and proper for their roles (i.e., possessing the necessary knowledge, skills and integrity for their positions), and has effective means to enforce this. (Market conduct)	The law contains detailed provisions governing the suitability and fitness of key functionaries and their continuing fitness for their positions. (Section 2.) It also includes provisions for the certification of actuaries and the licensing of brokers. (Sections 5 and 10.)

Table 5: Continued

Standards	**IAIS Standard**	**Status in RM**
Corporate Governance	It is desirable that standards be established in the jurisdiction that deals with corporate governance. Where the insurance supervisor has responsibility for setting requirements for corporate governance, the supervisor should set requirements with respect to the roles and responsibilities of the board of directors. The insurance supervisor has the authority to require boards of directors to clearly set out their responsibilities towards acceptance of and commitment to the specific corporate governance principles for their undertaking.	Sections 2 and 3 of the new law set forth detailed corporate governance provisions.
Consolidated Supervision	The supervisor has the legal authority to require companies to submit information on both a solo and a consolidated basis, on their financial condition and performance. The insurance supervisor should ensure that no foreign insurance establishment escapes supervision.	Section 11 of the new law includes detailed requirements for reporting information to the insurance supervisor.
On-site Examinations	The insurance supervisor should be able to carry out on-site inspections to review the business and affairs of the company. The supervisor has a framework for on-going monitoring of the condition and performance of the companies. The insurance supervisor requires that information is verified periodically through on-site examination conducted by himself, external auditors or other qualified parties.	Section 8 of the new law provides for internal audits, Section 9 provides for external audits on an annual basis, and Sections 11 and 12 provide detailed provisions for supervision, including on-site examinations.
Information Reporting and Disclosure	The information needed to carry out reviews and analysis is obtained from financial and statistical reports that are filed on a regular basis, supported by information obtained through special information requests, on-site inspections and communication with actuaries and external auditors. The insurance supervisor should be able to request and receive any information from companies licensed in his jurisdiction, whether this information be specific to a company or be requested of all companies.	The new law provides for the reporting of information to the insurance supervisor and authorizes the supervisor to obtain information through special requests and on-site examinations. (Sections 11 and 12, including Articles 207 and 208.)

Table 5: Continued

Standards	IAIS Standard	Status in RM
Information Reporting and Disclosure	Supervisors should ensure that insurers and intermediaries exercise the necessary knowledge, skills and integrity in dealings with their customers. The supervisor sets policy and guidelines with regard to disclosure to the customer of relevant, meaningful and understandable information in a timely manner.	Articles 49-52 of the new law include disclosure requirements for insurance. The requirements include specific information as to the insurer, policy terms and conditions, premiums (including any breakdown by risk and any additional charges), and other matters, as well as the insured's right to make a complaint to the Ministry of Finance.
Cross-Border Cooperation	The supervisor may choose to rely on the work carried out by an insurance supervisor in another jurisdiction. The creation of a cross-border insurance establishment is subject to consultation between host and home supervisors.	Section 3 of the new law includes detailed provisions relating to the supervision of insurers from foreign countries and cooperation with insurance supervisory authorities in other countries. (See also Section 11, Article 159.)
Confidentiality	All insurance supervisors should be subject to professional secrecy constraints in respect of information obtained in the course of their activities, including during the conduct of on-site inspections.	Section 5 of the new law sets forth detailed standards to protect the confidentiality of data.
Risk Management	The insurance supervisor requires insurers to have in place comprehensive risk management policies and systems capable of promptly identifying, measuring, reporting and controlling the risks associated with investment activities that might affect the coverage of technical provisions (policy liabilities) and/or solvency margins (capital). Standards should be established with respect to the assets of companies. Insurance supervisors should establish standards with respect to the liabilities of companies. The insurance supervisor should consider the amount of credit allowed to reduce liabilities for amounts recoverable under reinsurance arrangements. The insurance supervisor must be able to review reinsurance arrangements.	Section 4 of the new law contains detailed provisions governing the solvency of insurers. It sets forth comprehensive risk management standards, including formulas for the determination of solvency margins for both life and non-life insurers. It includes provisions relating to capital, assets, liabilities, reserves, and reinsurance.

Table 5: Continued

Standards	**IAIS Standard**	**Status in RM**
Internal Audit and Controls	The supervisor should be able to review the internal controls that the board of directors and management approve and apply. The supervisor has the authority to require that the insurer has an ongoing audit function.	Section 8 of the new law requires insurers to organize internal audit as an independent organizational unit reporting directly to the management board.
Capital	The requirements regarding the capital to be maintained by companies that are licensed, or seek a license should be clearly defined.	Section 4 of the new law includes specific requirements for insurers' capital. It includes safety provisions (Article 70) and required solvency margins (Articles 75 and 76) as well as specified "guarantee fund" amounts (Article 77).
Accounting Standards	A process should be established for setting the accounting requirements for the preparation of financial reports in the jurisdiction. The insurance supervisor requires insurance companies to utilize valuation rules that are consistent, realistic and prudent.	The new law includes requirements for independent audits. It authorizes the Minister of Finance to prescribe the form and content of audit reports. The law includes standards for investments (Section 4, Articles79-98).
Financial Crimes	The supervisor is informed about findings of investigations where the power to investigate fraud, money laundering, and other such activities rests with a body other than the insurance supervisor. The insurance supervisor has the authority to require that insurers have formal procedures to recognize potential suspicious transactions.	Section 8 of the new law relating to internal audits provides for submission to the Minister of Finance of the semi-annual internal audit reports, which are required to include any findings as to non-compliance and irregularities. Similarly, Section 9 relating to external audits requires the auditors to inform the Minister of Finance immediately if they find that the insurer has acted in breach of the risk management rules, has encountered a threat of non-liquidity or insolvency, or the safety of insurance is jeopardized.

2. *Insurance Supervision*

The Insurance Supervision Department of RM was established in the fall of 2000 and is situated within the Ministry of Finance. What is most striking about RM insurance is the pace of growth and development of its regulatory system. Less than two years ago there were only limited insurance laws, no insurance regulatory department, and apparently no insurance regulations. Today, there is a competent and dedicated staff of six professionals[25] in the Insurance Supervision Department. Three technical regulations been issued. In addition, a thorough, comprehensive and well-conceived insurance law has been drafted, and approved, by the Government. It is now pending in Parliament.

The Department has been involved, with technical assistance from Germany, Slovenia, and Estonia, with the development of the new insurance law. Implementation of the law poses a great challenge to the new and small insurance department. Most immediately, the Department will be required to draft and promulgate 24 by-laws (implementing regulations) under the law. In addition, it will be responsible for enhanced financial surveillance, licensing of companies and brokers, on-site financial and market conduct examinations, and enforcement.

The Department has already undertaken its first on-site examinations, of Tabak and Makoshped, and will produce detailed reports of examination. It has also (for the first time) created a database for the entire insurance industry. This database includes all balance sheet data. Previously, the only insurance data available were those included in the annual reports submitted by the companies. The Department has also produced three by-laws, relating to the solvency margin for life insurance, the solvency margin for non-life insurance, and procedures for applications to and actions by the Department. The inclusion in capital of two reserve accounts, relating to catastrophes and prevention, raises issues of adequacy of capital and accurate presentation of taxable income for Macedonian insurers.

The Department is open to the public, but is not available as a forum for the resolution of disputes relating to claims. The Department's objective is to build public confidence about insurance, and to enhance the awareness of insurance as a provider of security.

The Department welcomes major foreign insurers, and there is no discrimination against foreign insurers. Minimum capital requirements for new insurers have not been increased under the new law. However, with the separation of different lines of insurance in the licensing requirements, minimum capital requirements were reduced for those insurers that wished authorization for fewer lines of insurance.

The Department has already undertaken enforcement actions. An unregistered company, Tam Insurance Company, was found to be operating without a license. The Department brought a halt to its operations.

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[25] Until very recently, the staff consisted of the head of supervision, three others, a lawyer and two economists. A mathematician and a third economist have recently been hired, bringing the total complement to six.

Key areas of weakness where the Department would benefit from technical assistance include licensing procedures for brokers and certification procedures for actuaries. At present, there is only one actuary in RM, and he is more than 60 years old. The Department would also benefit from financial support for membership and participation in the activities of the International Association of Insurance Supervisors.

E. *Other Non-Bank Sectors and Institutions*

There is very little activity outside of the core formal financial institutions and markets. Mortgage finance is underdeveloped, with only one bank (i.e., Tutunska) reported to be making loans for housing finance. There may be other activity, such as periodic loans for premises (e.g., acquisition, improvements, expansion), but these are infrequent. Real estate transactions are generally private transactions, and rarely run through the formal institutions. There is also a host of other issues that have constrained the evolution of this market, although one positive finding is that there is a tradition of private residential ownership, and transfer of title is feasible. However, for the market to take off, several other areas will need to be addressed, including municipal government, land use planning and site management, and the provision of needed utilities. Beyond that, there is the fundamental issue of inventory, as there have been few bank loans, and no mortgage bonds. However, there is potential for this market to take hold, and it already constitutes nearly 3 percent of GDP[26].

The leasing market is another market that has yet to take hold in RM. While there is a Leasing Law, there is no major activity. Some auto finance companies are reportedly engaged in leasing, but these are more accurately described as commercial finance loans rather than financial or operating lease activity. Prudential requirements limiting banks' fixed assets to no more than 100 percent of capital serve as a deterrent to banks to acquire equipment and premises they could subsequently lease out.

Micro-finance has grown considerably under the Moznosti program, originally an NGO program that subsequently obtained a savings house license and is now contemplating becoming a licensed bank. Credit unions have not fared as well, largely because they have had difficulty mobilizing enough local currency savings to lend and attract more members. Both represent attract alternatives to traditional commercial banks for very small accounts and loans. However, currently, their figures are small compared with system aggregates.

[26] According to the State Statistical Office, "real estate, renting and business activities" were 2.76 percent of 2000 GDP, or about 6.5 billion denars of activity.

VI. Current State of the Financial Sector

A. Banking Sector Profile and Trends

1. Structure and General Ownership Characteristics

The Macedonian banking system is composed of 22 banks and 19 savings houses. Among the banks, the two major ones[27] on a balance sheet basis are private, and accounted for 51 percent of credit, 58 percent of assets, 89 percent of deposits and 33 percent of capital as of end 2000. Thus, there is a high level of balance sheet concentration in the banking sector, particularly on the deposit side, with most real sector deposits placed in the two largest banks. Savings houses are relatively small in terms of balance sheet measures. However, they reportedly had 6-7 percent of total household deposits in 1999-2000. Thus, these savings houses are material enough to monitor for ongoing stability and continued progress towards household depositor confidence in formal financial institutions.

Among the 22 banks, at least seven have foreign ownership. These banks include Stopanska and Tutunska, respectively the first and third largest banks in the system. Komercijalna remains RM's largest majority-domestically owned bank, with minority participation from foreign investors. Foreign investment in banks amounted to DM 217 million in 2000, which was equivalent to about 59 percent of RM's total foreign direct investment[28]. Together, foreign banks account for a sizeable portion of credit, assets, and deposits, mainly due to Stopanska and, to a lesser extent, Tutunska. However, their capital and reserves are not major[29]. To date, foreign banks have also not made a major change in lending patterns. In fact, none of the banks (domestic or foreign) have played anything but a minor role in incremental lending. On the other hand, new investors frequently need time to get systems in place, appoint new management, and study the market in greater detail than prior to the purchase. This may be the case with several banks. In the case of Stopanska, they uncovered more non-performing loans than they had realized in 1999-2000, adding Euro 45 million in loan-loss provisions while also attending to the introduction of new systems, procedures, controls and personnel training and reorganization. More generally, the economy has enjoyed very little stability since 1999, with the Kosovo refugee crisis and then the internal disturbances that disrupted the market in 2001. Recent problems in Turkey may also have limited the ability of Ziraat to play much of a role, while the Russian and Bulgarian banks are small to start with.

Only one bank, the Macedonian Development Bank, is state-owned. It is a non-deposit-taking bank, and its role is generally to promote exports and provide trade finance facilities (e.g., secured loans backed by export receipts and guarantees) to private sector companies. The bank is also set up to

[27] Stopanska Bank and Komercijalna Bank.

[28] DM 216.7 million was about $103 million. Foreign direct investment (net) in RM in 2000 was $176 million.

[29] For instance, Stopanska, Tutunska and Kreditina combined only had 19 percent of total system capital at end 2000. This share likely increased by end 2001. However, these are still not major investments in aggregate terms.

administer donor lines of credit. This bank has a very small share of the market. KfW (of Germany) assists the bank.

On average, banks are small in RM, complicating the supervisory effort and raising questions about long-term sustainability. Low levels of capital restrict the size of loans these banks can make, while weak earnings limit the amount of investment they can make in new systems for non-credit earnings sources (e.g., foreign exchange trading, brokerage, corporate finance advisory).

State ownership has not been a constraint in terms of opening up the banking system to private control. RM has permitted private banks to operate since the early 1990's, and the 1999 privatization of Stopanska effectively removed the state from most active involvement in financial intermediation. However, many of the smaller banks were "privatized" through the ownership transformation of the companies that owned them. This approach, as in much of the CIS, has proven to be ineffective in improving the governance and management of banks. Moreover, there are reports that Government does intervene through the use of its deposits placed in banks to influence lending and other decisions.

With the second round of economic and financial problems that were in full view by 1999, the Government and NBRM introduced tougher prudential norms to stabilize the banks. Meanwhile, new legislation was drafted to enhance creditor rights when debtors are in default, and the transformation of the ZPP system was agreed to in favor of better payment systems and improved collateral registries. Perhaps even more importantly, a key turning point in getting the banking sector on the path to commercial viability was facing up to the challenge of loss-making enterprises that had close ties with the Government. Earlier practices had seen many smaller banks used as conduits for directed lending, only to lead to an accumulation of losses that had increased due to such connected lending practices. While the Government is still permitting a measure of forbearance for these enterprises to restructure, there has been less use of the banks as a conduit for cheap or preferred financing. Lending flows in recent years suggest the banks are adopting stricter criteria before approving loans and making disbursements. This has worked both ways, as enterprises have also withdrawn deposits from the banks, while running up arrears to other creditors (e.g., utilities companies, first pillar pension fund, other enterprises).

2. *Basic Trends in Financial Intermediation*

RM's measures for financial intermediation are low, although not as low as some of the other transition countries where banking system development has stalled, confidence is low, deposit mobilization potential is limited, and access to other sources of financing are weak or non-existent. In RM's case, banking system development has been delayed for many reasons, not the least of which has been political disruption in the Balkans and, more recently, in RM itself. However, the Government has made a good start since 1999 in moving ahead with reforms, and the results were beginning to show in 2000-early 2001 prior to the disturbances. Further, the recent rise in deposits suggests that reform efforts are beginning to contribute to a restoration of household confidence, even if a major share of incremental deposits mobilized in December 2001 eventually leaves the banking system. Moreover, RM has access to external sources, its current debt profile is manageable[30], there are bank deposits/reserves abroad in safe foreign currencies, and the country's open current account allows money to be exchanged and transferred fairly freely. Thus, while intermediation levels are not high, funding trends are positive. The chief risk RM faces is further political discord, and the consequent flight of capital out of the country.

Intermediation rates still remain fairly low despite positive trends since 1997. Broad money measures (M3) were only 21 percent of GDP (end 2000), although they increased to 34 percent by end 2001 and have increased steadily as a percentage of GDP since 1997. This is encouraging, as it shows that RM is attracting an increasing share of savings to/through formal institutions. However, this is partly overstated due to the relatively low GDP figures that are used to calculate financial intermediation statistics[31], and the spike experienced in December 2001 due to the Euro conversion.

Some of the problem associated with developing a stable funding base has to do with the battle to restore confidence after hyperinflation and the freezing of foreign currency accounts in the early 1990s. In the case of the former, this was not all together different from the challenge faced by virtually every transition economy at some point[32]. However, the freezing of foreign currency accounts was fairly specific to the politics of the former Yugoslavia. In response to the freeze, several former Yugoslav countries issued bonds to be amortized over long periods (10-20 years) to compensate households for lost savings. RM was among these countries, issuing DM 1.1 billion in bonds in 2000 to be amortized over a period of 10 years (with a two-year grace period for principal). In 2000, interest at 2 percent annualized was redeemed (about $10.5 million), freeing up funds for households and small enterprises for basic transactions, savings and investment[33]. This has been a contributing factor to the increase in deposit mobilization that began to accelerate in 2000. However, at only $262-equivalent in per capita deposits[34] held with the banks (end 2000), deposit levels remain low. NBRM is cautiously estimating that 50-75 percent of incremental deposits in 4Q 2001

[30] External debt to GDP was only 43 percent at end 1999, and was not projected to rise above 51 percent through 2003. Even if it rises above that level, it is sustainable. See "Memorandum of Economic and Financial Policies", IMF, November 15, 2000. According to NBRM, the stock of external debt was $1,382 million at June 30, 2001, about 43 percent of estimated GDP for 2001.

[31] If PPP per capita income figures were extrapolated to full GDP, M3/GDP would have approximated 7 percent rather than 21 percent of GDP in 2000. With a population of 2 million and PPP per capita incomes of $5,027 in 2000, GDP by this measure would have approximated $10.2 billion, or 677 billion denar. This would have translated into M3/GDP of about 13.7 percent: 45,686/676,885 = 6.75 percent.

[32] Only three transition economies kept peak inflation rates in double digits, and never experienced inflation rates of 100 percent or more. These countries and their peak rates were the Czech Republic (20.8 percent in 1993), Hungary (34.2 percent in 1991), and the Slovak Republic (61.2 percent in 1991).

[33] These bonds are flexible in their use, and can be used to buy land from the state, pay taxes at face value, and settle a number of outstanding accounts if in arrears to the Government.

[34] $531 million/2.03 million = $261.6 per capita. Figures derived from IFS data.

will remain in the system. Should deposit levels remain in that range, per capita deposits in 2002 should approximate the equivalent of $366-$410[35].

Poverty in rural areas has been a contributing factor to relatively low levels of deposits. In these areas, poverty is widespread[36], and trust in banks and other formal financial institutions is limited. This lack of trust is grounded in the experience of the early 1990s, but also partly influenced by the pyramid scheme debacle in Albania in 1997[37], events in Kosovo through 1999, and recent domestic difficulties in RM. There has also been a high level of commercial trade that is private, unrecorded, and largely informal. The IMF projected a large "errors and omissions" item in the balance of payments for 2000-2003[38], attributed to unrecorded trade. This translates into a high proportion of cash sales, or sales on credit through informal institutions based on family/clan connections and a desire to avoid taxes. With the transformation of ZPP and movement towards a more modern payment system, it is the Government's objective to have more transactions run through the formal financial system. If achieved, in the long run, this will help broaden the fiscal base. However, the current financial transactions tax undermines these developments.

As elsewhere throughout the region, one of the major challenges RM banks face is generating a reasonable funding base to be able to provide a meaningful array of financial products and services. Apart from cash transfers and some trade finance, the larger banks provide very limited services. This is shown in non-interest income figures of only $77 million-equivalent in 2000, or only $3.5 million per bank. With average bank assets of $58 million at end 2000 and $75 million at end 2001, this represents fairly low productivity from existing assets[39]. In general, service offerings are limited, and most of the non-interest income is derived from basic foreign exchange trading, and simple trade finance and transfers. If RM is able to replicate trends elsewhere in the region, increasing competition among the bigger banks for the business of the limited commercially viable corporate sector will eventually translate into narrower margins, triggering a push into consumer banking. NBG (Stopanska's main shareholder) is currently doing this in Bulgaria[40] and elsewhere throughout the region, and is expected to pursue a similar approach in RM over time. However, it will take time for competitive retail banking to take hold. Until then (and other reform measures are in place that

35 Lower Scenario: $564 million + (0.5*$358 million) = $743 million. Per capita: $743 million/2.03 million = $366. Higher Scenario: $564 million + (0.75*$358 million) = $833 million. Per capita: $833 million/2.03 million = $410.

36 About 20 percent of the total population is considered to be below the poverty line. See "Memorandum of Economic and Financial Policies", IMF, November 15, 2000.

37 Losses from the pyramid schemes in Albania were estimated to be $1.2 billion. At least one source has noted that the nominal value of the pyramid schemes' obligations—$1.7 billion at their peak— approached half of Albania's GDP. (See Jarvis, "*The Rise and Fall of the Pyramid Schemes in Albania,*" IMF, July 1999.) Losses of $1.2 billion approximated 45 percent of average GDP from 1997-98 (based on nominal GDP figures from the IMF).

38 See "Memorandum of Economic and Financial Policies", IMF, November 15, 2000. NBRM reported "errors and omissions" were only $68 million-equivalent in 2000, or 2 percent of GDP. However, unrecorded trade may have been much more than 2 percent of GDP.

39 2001 earnings were not available as of late January 2002.

40 NBG is the main shareholder in United Bulgarian Bank.

show sustainable growth of per capita incomes), deposit mobilization may stay relatively low on a per capita basis.

In RM, recent trends suggest that household depositor confidence and that of Government and other depositors is increasing, while the role of the enterprise sector is declining. Part of this reflects the tightening of lending conditions in the aftermath of major arrears and defaults that pushed the banking system to near collapse in the late 1990s[41]. The enterprise sector showed an estimated net decline in deposits of $70 million in 2001 and declining net deposits into the banks in 1999-2000. Meanwhile, households' increased aggregate deposits by a massive estimate of $372 million in 2001 after a $45 million increase in 2000. Along with other reports of increased inter-enterprise arrears[42], the deposit withdrawals point to financial difficulties faced by enterprises as banks tighten up their lending criteria, and as enterprises are faced with the difficult challenges of becoming more competitive. For households, confidence appears to be returning.

From a liquidity standpoint, banks are maintaining high liquidity ratios. Based on September 30, 2001 data, banks had 39 percent of their assets in cash and balances with NBRM, NBRM and Government securities, and inter-bank loans. This represents a decline from end 2000 NBRM figures, when the banks had about half of their assets[43] in cash and balances with NBRM, securities rediscounted by NBRM, Government and other short-term securities, and inter-bank loans (usually no more than a few days). These figures may have changed at end 2001 due to the massive influx of deposits. However, accounts with foreign banks abroad declined by September 30, 2001, to 16 percent[44] from nearly 30 percent[45] of total assets at end 2000. Meanwhile, special reserves for loan losses were 31 percent[46] of loans to enterprises, households and other customers at end 2000 (not reported for 2001), and a high proportion of additional reserves were set aside for potential losses from accrued interest[47]. It is conceivable that preliminary estimates of a decline in net capital relate to charge-offs to capital for non-performing loans. In any event, banks are being cautious in terms of how they manage their resources, both for adequate liquidity as well as for regulatory compliance with capital adequacy and other measures.

Banks faced a tightening of compulsory reserve requirements in 2001 from 8 to 10 percent for sight deposits[48], and 3.5 percent to 5 percent for time deposits over three months[49]. This tightening, along with past loan portfolio problems continue to raise intermediation costs of banking in RM. Current

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41 The Government had to assume DM 235 million in non-performing loans as a precondition for selling Stopanska Bank in 1999. This approximated nearly 40 percent of end 1998 net capital of about $320 million.

42 See "Memorandum of Economic and Financial Policies", IMF, November 15, 2000.

43 40,758 million denars/81,999 million denars = 49.7 percent.

44 14,780 million denars/92,610 million denars = 16.0 percent.

45 24,154 million denars/81,999 million denars = 29.5 percent

46 9,020 million denars/29,240 million denars = 30.9 percent.

47 3,547 million denars/4,293 million denars = 82.6 percent.

48 From 8 to 9 percent in May, and then to 10 percent in June.

49 From 3.5 to 4 percent in May, and then to 5 percent in June.

efforts to reform the payment system will help with more efficient liquidity management. However, banks still showed real net spreads between loan and deposit rates of about 9.5 percent in 2001, above the 7.1 percent recorded in 2000. The 2001 rate is comparable to rates from 1997-99, yet remains high when compared with EU norms[50].

Given the still emerging funding base and a cautious approach to liquidity management, banks are limited in terms of their resource base for lending. This reduces earnings (and capital build-up) opportunities, and could potentially provide an incentive for adverse selection once the regulatory authorities ease up on their monitoring of corrective actions taken by troubled banks. With a relatively small per capita deposit base, there are limitations on what banks are likely to do in terms of innovation (e.g., credit cards, e-banking, tele-banking) to bolster their consumer/retail banking presence, although some have clearly thought about these prospects and are investigating or have introduced credit cards, debit cards, payroll services, etc. Meanwhile, underdevelopment of the securities, contractual savings (i.e., pension and life insurance) and mortgage finance markets limits diversification opportunities, thereby reducing the push for retail banking.

Particularly when prudential requirements force banks to shore up capital and liquidity, they usually revert to risk-averse behavior (which is prudent). This tends to translate into investment in Government securities, or in relatively risk-free placements abroad. This generally occurred in RM in 2000, and may have occurred towards the end of 2001. While bank investment in Government securities decreased in 2000, banks significantly increased their holdings of securities rediscounted by NBRM. Meanwhile, placements with foreign banks abroad also increased. All together, banks' net increases in these assets approximated $102 million[51] in 2000, while net real sector loans were basically flat, either marginally positive (in denars) or negative (in dollars) depending on the currency or exchange rate used. While investment in foreign bank assets may have declined throughout much of 2001, lending clearly did as well by about negative $22 million-equivalent.

Rather than there being a high level of monetization in the economy, RM can point to recent improvements in deposit trends and capital levels that should continue. When combined with other macroeconomic and structural measures, broad money and overall lending figures should increase and approach the better performing regional standards (relative to GDP) of 30 percent or more. In fact, end 2001 broad money figures put RM in that category, although 2001 was extraordinary in terms of the Euro conversion (pushing up year-end deposits) as well as political instability (lowering GDP). With money expected to exit the banks and GDP to grow (assuming political stability), broad money ratios would not be expected to exceed 30 percent. In either case, it will still take several years before RM shows lending and overall intermediation figures that approach EU or OECD norms. For instance, the Euro area showed banks claims on non-Government sectors to be 107

[50] For instance, net spreads in the Euro market were about 3 percent at end 2000.

[51] Net changes in 2000 vs. 1999: (i) Government securities: -792 million denar; (ii) securities rediscounted by NBRM: 2,660 million denars; and (iii) accounts with foreign banks: 4,870 million denars = Net Total change of 6,738 million denars, or $102 million.

percent of GDP (end 2000)[52]. Meanwhile, in the United States, banking institutions reported claims on the private sector to be only 49 percent of GDP[53]. However, the role of the banking sector is comparatively less prominent in the US than in Europe due to the role played in the US by credit unions, savings institutions, money market funds, the capital markets[54], etc.

With regard to lending, the amount of outstanding credit to the private sector stood at 42 billion denar ($636 million) at end 2000[55] against total deposits of 34 billion denars ($511 million)[56]. These figures are estimated to have reversed in 2001, with non-government deposits of about 56 billion denars ($812 million), while credit to the private sector would only be about 31 billion denars ($454 million). Even if the estimated figures are off, the trend appears to be towards hardened lending positions by the banks in 2001. The political tensions were primarily responsible, and the major influx of deposits was not until December 2001. Thus, lending is not likely to increase at least until the second quarter of 2002, if at all.

Most of the existing stock of credit is to non-government, and mainly to the "private sector". However, on a flow basis, credit has been negative to the real sector every year since 1997 except 1998. On a cumulative basis, net credit flows to the private sector were negative $677 million from 1997-2001, negative $62 million to the public and socially owned enterprise sector, and negative $41 million to the Government. In 2000, banks generally placed their incremental deposits with the Government, or in banks abroad, rather than in new lending. As noted above, this occurred at about a 3:1 ratio in 2000, and will likely show a similar pattern when final 2001 figures are presented. Again, due to banks' requirements to fully comply with regulations, this is actually prudent behavior. Banks' capacity to meet capital adequacy, foreign currency and liquidity requirements is more easily met by placing funds with Government or in safe banks/currencies/securities abroad. Moreover, given the long track record of loan default in the enterprise sector, banks have been unwilling to assume excessive risk. With 12.6 billion denars ($190 million) in special reserves for potential loan and interest losses and an additional 934 million denars ($14 million) in provisions for off-balance sheet liabilities at end 2000[57], the banks are hesitant to take on much credit risk under the circumstances. The net decline of enterprise deposits in 2001 also provides banks with less incentive to cater to many of the enterprises' needs, although this also represents a vicious cycle for both parties concerned.

52 Euro 6,865 billion/6,432 billion = 106.7 percent.

53 $4,846 billion/9,963 billion = 48.6 percent.

54 For instance, at end 2000, US credit unions and savings institutions had an additional $1,478 billion in claims on the private sector, equivalent to 14.8 percent of GDP. Stock market capitalization would push these ratios well above 100 percent of GDP, even after corrections.

55 Based on IFS, but after netting out public and social enterprise exposures as reported by NBRM. NBRM reported only about 26 billion denar in loans to enterprises, households and other non-government institutions.

56 Figures are from "Bulletin II & III", National Bank of the Republic of Macedonia, November 2001.

57 See "Annual Report: 2000" Appendix 1, National Bank of the Republic of Macedonia, March 2001.

It should be noted that while lending has been limited for several reasons (more fully discussed in Annex 1 on Banking and Financial Intermediation), RM credit figures are comparatively high for transition economies, particularly relative to CIS. The following table shows that credit-to-GDP figures on a stock basis are higher than CIS countries, roughly equivalent to the average for the three Baltic states, but lagging the better performers among the countries of Central Europe. However, there are two broad caveats to these figures. First, they are stock measures, not flow measures. On a flow basis, total bank credit has clearly diminished since 1997. Second, these figures do not necessarily account for quality, or net credit values, should they be tested for performance. Thus, the percentages might decline in several countries should that test be administered. Nonetheless, based on available and relatively comparable data, RM's year-end 2000 and 2001 data indicate that its credit-to-GDP figures are not unreasonable relative to regional performance.

Table 6: Comparative Credit to Enterprise Ratios as a Percentage of 2000 GDP

0-3 percent of GDP	None
3-5 percent of GDP	Kyrgyz Republic
5-7 percent of GDP	None
7-10 percent of GDP	Azerbaijan, Georgia, Romania
10-15 percent of GDP	Albania, Kazakhstan, Lithuania, Moldova, Russia, Ukraine
16-25 percent of GDP	Belarus, Bulgaria, **Republic of Macedonia**, Latvia
> 25 percent of GDP	Croatia, Czech Republic, Estonia, Hungary, Poland, Slovak Republic, Slovenia
Notes: all figures based on domestic credit to enterprise and GDP figures for 2000 from IMF (IFS) for 2000. More successful countries generally > 30 percent of GDP. Figures not available for Bosnia-Herzegovina, Tajikistan, Turkmenistan, Uzbekistan, Yugoslavia	
Source: IMF (IFS)	

B. Non-Bank Financial Institutions and Markets

1. *Overview*

The non-bank part of the financial sector is less developed in RM than the country's banking system. The capital markets are basically geared to Government financing with bonds listed on the first market of the MSE and Government auctions accounting for 71 percent of turnover in 2001 (on a denar basis). There are 10 brokers licensed to trade on the Exchange. However, most trading activity is not on the first market, where information disclosure is greater. Privatization has mainly been through management-employee buyouts, and shares have traded off-market in non-transparent ways. There are no active investment funds operating on the market. Pension reform in under way, and private pension funds will be licensed to manage second pillar funds. However, as of early 2002, there are no private pension funds. The insurance industry has only four active companies, and one accounts for nearly 90 percent of market activity. Premium revenue was only $84 million-equivalent in 2000.

2. Securities/Capital Markets

There is a limited securities market at the moment, and this is focused on the Government Treasury bill market and bonds issued to citizens for frozen foreign currency accounts. Despite an open and fully convertible current account, there is no portfolio investment in the form of short-term capital inflows.

Due to the political instability of 1999 and 2001, there has been little focus on moving the MSE ahead. The authorities have plans to diversify activity on this market, but this is mainly in the form of more open market operations in the implementation of monetary policy. This has already begun, as Government lifted credit restrictions on banks in April 2000, and as the Government conducted daily auctions in much of 2001 to defend the exchange rate during the period of internal disorder. However, movement towards a viable equity market has been unsuccessful.

There is clear financial potential to develop a liquid market. According to NBRM figures, private transfers averaged about $432 million from 1998-2000, which was about 34 percent of merchandise exports, 7.5 times official transfers[58], and nearly 4 times direct investment during the same period. (The table below highlights some of these figures.) On top of this, significant deposits entered the banking system in advance of the Euro conversion in late 2001. While a significant portion of these deposits can be expected to be placed in other markets, or withdrawn from the Macedonian banking system in the first half of 2002, their presence at end 2001 suggests they could be attracted back to the local market should attractive opportunities emerge. A third reason for potential development of the market is the possible privatization of utilities and other infrastructure-related companies. Should any of these shares be tradable on the MSE, this would provide some opportunity to increase the liquidity of the market. A fourth area for development would be the gradual devolution of administrative functions to municipal levels, and utilization of the markets for bond financing. A fifth area of possible development is in the area of mortgage financing, including securitization.

[58] Official transfer figures only apply to the capital account. Current account figures for 1999 official transfers related to the Kosovo crisis are not included, although extraordinary funds are reported to have come to RM to assist with the refugee crisis.

Table 7: Private Transfers (1998-2001)

	1998	1999	2000	2001
Net Current Private Transfers (US$)*	326	420	551	165
GDP (millions of US$; y-e rates)	3,681	3,236	3,274	3,166
Private Transfers/GDP (%)	8.9%	13.0%	16.8%	5.2%
Merchandise Exports (US$)*	1,293	1,192	1,317	1,151
Private Transfers/Exports (%)	25.2%	35.2%	41.8%	14.3%
Official Transfers (US$)*	28	65	80	21
Private Transfers/Official Transfers (%)	1165.7%	646.3%	688.4%	771.0%
Direct Investment (US$)	118	30	169	410[59]
Private Transfers/Direct Investment (%)	276.6%	1395.7%	325.9%	39.8%
Notes: * means 2001 figures are from June 30 and then annualized except direct investment (due to extraordinary inflows in January); private transfers may be understated for 2001, as they reportedly increased significantly in 4Q 2001; 2001 GDP figure is estimated				
Source: IMF, NBRM; World Bank				

Real potential exists to develop this market. However, market development is largely constrained by a host of business sector weaknesses that are too numerous to list, but include (i) legal framework weaknesses, experience and traditions, and judicial capacity to enforce; (ii) corporate governance standards and practices, and general business management and planning capacity; (iii) weak financial disclosure, and the veracity, timeliness, adequacy and completeness of information; (iv) an inadequate corporate and personal tax base, as reflected in the low percentage of fiscal revenue from these sources; (v) broad distrust of formal institutions; and (vi) general lack of experience and tradition in formal market-based activity, including recognition of the value of open information flows for market development.

Market development is also constrained by the absence of institutional capacity and financial instruments in the capital markets. Legal reform is being pursued, regulatory and supervisory structures are in place or being put in place, and Government is using the market for some of its financing needs. However, there are numerous gaps that make it difficult to attract capital, introduce long-term instruments, establish needed infrastructure (e.g., market research, rating agencies), and generate the kinds of information flows needed to build market capitalization and turnover. Key weaknesses that impede market development include (i) the absence of institutional investors (e.g.,

[59] There was an extraordinary inflow of direct investment resulting from the privatization of Macedonian Telecom (about Euro 342 million). In January 2001, direct investment was $333 million. From February-June, the total for all five months was $35 million. The 2001 figure assumed a $7 million average from February-December ($77 million) on top of the January figure.

pension funds, investment funds, insurance companies); (ii) the absence of suitable instruments under stable conditions that might induce investors to take risk in the markets; and (iii) the absence of market information flows (e.g., analysts) and mechanisms for viable ratings (e.g., domestic credit/bond rating agencies) to provide the public with some comparative assessment of prospects. Some of these building blocks are summarized below.

Table 8: Summary of Major Constraints to Capital Market Development

Activity	Status	Critical Areas of Needed Development
General Economy	Positive performance in light of difficult circumstances and shocks. Macroeconomic discipline has been shown in low inflation rates, relative fiscal balance, and stable exchange rates, but high unemployment rates. Structural weaknesses in the enterprise sector and business environment undermine incentives to invest.	The macroeconomic framework has been among the least of RM's constraints. Most broad indicators are reasonably sound, except investment financing and official employment. Most problems relate to the political uncertainty and associated market risk, all of which make it difficult to build capital and other markets.
Business Climate	Weak. Lack of adequate financial information and disclosure. Good projects not communicated or supported by credible business plans. Tradition of loan default.	RM needs to enhance institutional capacity for reforms to take hold. Better governance and management standards are required to attract financing, debt and equity. This requires more disclosure of accurate and timely information, capable and active boards, competent management teams, better market research and strategy, strengthened cash and financial management, and integrity and regular communications with shareholders and other stakeholders (creditors, employees, etc.).
Political Climate	Uncertain. Undermines planning capacity, disrupts operations, deters direct investment, and constrains development of financial markets.	Effectiveness of municipalization may prove to be one of the key elements in making the power-sharing agreement work. This will require high standards for public administration, institutional capacity building for sound management and planning purposes, development of local fiscal bases, and use of local markets for financing once these conditions are in place (see "Municipal Bonds" below).

Table 8: Continued		
Activity	**Status**	**Critical Areas of Needed Development**
Corporate Bonds	No current activity. Law permits trading, but no real tradition or infrastructure in place.	As per "Business Climate", market development in RM requires more and better information, ability of the market to evaluate/rate these securities, and recognition by companies of the need for corporate debt instruments of various maturities. This presupposes large companies with major investment requirements. This might be accommodated with innovative schemes; such as traditionally public services (e.g., health management) that are either privatized, or remain public but lease back premises, equipment, instrumentation, etc. from private suppliers. Bond rating system needed.
Municipal Bonds	No current activity. Municipalization being introduced as part of the agreement to end discord. General municipal finance capacity lacking.	Currently premature, as broad infrastructure and municipal capacity in general are inadequate. The feasibility of these bonds is predicated on having a viable fiscal base, usually based on property assessments, users fees, sound prospects for continued business growth, and assets that could be sold. Also required are adequate services (e.g., water and sewerage, site management, land use planning). Bond rating system needed.
Corporate Equities	Only one stock listed on the First Market of the Exchange. Most shares traded off-market where disclosure requirements are low or nil.	Listings on First Market undermined by poor financial condition of many companies, weak accounting and management, and unwillingness of investors to disclose information due to tax and other reasons. Privatization by MEBO has distorted incentives, and provided an incentive for entrenched management to remain off-market.
Venture Capital	One venture fund that is donor-financed. Thirteen investments made to date averaging about $423,000. No exit mechanism available.	Inadequate presentation of feasible projects for major risk-takers. Investments can be management-intensive due to firm-level weaknesses. No exit mechanism via MSE (or proposed OTC). Weak fundamentals for most manufacturers, and small number of high value service providers.

Table 8: Continued		
Activity	**Status**	**Critical Areas of Needed Development**
Leasing	Law being drafted. No real lease finance, although some auto finance activity that is called leasing.	Adoption of a law that provides tax and accounting incentives (e.g., generous depreciation allowances for equipment) for development not understood. Need to reconcile law with CARs of banks (i.e., fixed asset ratios) and enhance risk assessment capacity of banks to comply with forward-looking regulations. Could be useful in farming, agro-processing, manufacturing, and key services (e.g., health care, education, information service providers).
Mortgage Finance	Private housing and property market exists. Real estate is about 3 percent of GDP. Reported clarity of ownership and ability to transfer title for residential properties (including land). Very limited bank lending for mortgage finance. Term aspect of the financing appears to be the greatest constraint, not traditional legal/court issues found in many other transition countries.	Mortgage finance is premature, particularly for capital markets applications. Legal framework for clear ownership rights, title transfer, and contract enforcement appear satisfactory. However, there is virtually no bank portfolio or specialized lender portfolio of mortgages for housing or commercial properties. Information for banks to establish loan-to-value parameters is just beginning to be compiled by private real estate firms. No existing basis for mortgage-backed securities. Development of mortgage bond portfolio for packaging will require ratings before sale, and institutional investors (e.g., pension funds, insurance companies, possibly banks) to make the sale. Mortgage bond (credit) rating system needed for bonds and securitization.

3. *Insurance*

At present, there are four insurance companies domiciled in RM. According to data provided by the Insurance Supervision Department, annual premium volume of the four insurers totaled 5.5 billion denars ($84 million) in 2000. This figure was down slightly from 5.6 billion denars in 1998 and 6.0 billion denars in 1999. Gross profit in 2000 was 57 million denars, down from 300 million denars in 1998 and 273 million denars in 1999. The loss ratio for the industry (on a paid rather than incurred basis) has been about 60 percent, with 1999 the best of the three years. Total assets have grown from 8.5 billion denars in 1998 to 11.2 billion denars in 2000, while capital has grown from 2.3 billion denars to 2.9 billion denars during the same period, resulting in significant improvement in the industry's premium-to-surplus ratio. The data provided do not break down the experience by line of insurance.

There is a high level of concentration. The largest of the four Macedonian insurers is Insurance QBE Macedonia. This company is the former state-owned insurer, ADOR or ZOIL Makedonija, which was founded in 1945. It was privatized in 1999 and acquired by QBE Insurance Group of Australia in March 2000[60]. At present QBE is approximately 65 percent owned by Australian investors, 15 percent by the state-owned pension fund (as a result of requirements for privatization), and 20 percent by others, primarily employees. QBE has approximately 1,000 employees, and accounts for about 90 percent of the national premium volume (2000 data), although this market share is expected to decline slightly for 2001 in light of growth of new, smaller companies. QBE provides industrial property, civil property, transport, motor vehicle, and agricultural insurance. It provides a limited amount of liability insurance, including aviation hull and liability. It also insures the property of the Electricity Supply Companies with a special gross premium tariff. QBE is the only insurance company in RM to issue life insurance policies.

Other companies include AD Vardar Skopje, Tabak and Makoshped. Vardar's market share is approximately 8 percent, and approximately 60 percent of its business consists of motor vehicle coverage. Tabak and Makoshped each account for just over 1 percent of the national premium volume.

There are several weaknesses and problematic practices that permeate the insurance sector. These include (i) management capacity; (ii) difficulties effecting cancellation for non-payment of premiums; (iii) uncollected premiums, and the practice of carrying non-paying policyholders for lengthy periods of time, retaining the obligation to pay claims despite the absence of premium payment (until deducted from the claim payment), and resulting in pressure to write more such business to maintain levels of written premium; (iv) payments of sums of money as special commissions or rebates in connection with the placement of business, including types of payments that would not be acceptable under Western standards[61]; (v) abuse with respect to claims, including alleged corruption in the judiciary; (vi) political influence in banking and insurance, including diversion of customers for reasons other than price, strength of the company, and quality of service; and (vii) a limited selection of earning assets in which to invest.

Challenges facing insurance firms internally include (i) reducing the number of employees in both administration and sales (at QBE); (ii) improving training of personnel; (iii) improving service, especially to major customers; (iv) upgrading claim adjustment procedures; (v) reducing bad debt; (vi) improving productivity of sales personnel; and (vii) finding and retaining good local managers to operate the business.

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60 AIG reportedly came within a week of acquiring the company, but withdrew as a result of the hostilities in Kosovo. QBE Insurance Group owns insurance companies in other countries in the region (Hungary, Bulgaria, Slovakia, Ukraine, and Moldova).

61 This comment was from a senior insurance industry executive.

As for rate-setting, tariffs for compulsory motor vehicle insurance and other lines are set by insurers and made available collectively by a trade association, the National Insurance Bureau, with the approval of the regulatory authorities. The tariffs, which include the allowances for claims but not acquisition and administrative expenses, are apparently published in the newspaper. There is some variation of rates among the four companies on the basis of differing expense allowances. QBE is typically the most expensive. A major problem is the high number of drivers who are uninsured. The proportion of uninsured drivers, which has apparently increased during the recent hostilities, is estimated to be 25 percent or more. Rates for other coverages apparently vary relatively little among the companies. Rates for coverages other than motor vehicle are filed with the regulator, but apparently are not challenged. New entrants into the market would be able to charge lower rates if they wished. Almost all reinsurance of the three smaller companies is placed with QBE.

Life insurance is undeveloped, and these premiums account for about 1.6 percent of overall premiums in the industry. Only QBE writes this line. However, while its writings increased from 61.4 million denars in 1998 to 88.5 million denars in 2000, its premiums overall declined from 5.3 billion denars to 4.9 billion denars during that period. As a result of the very high inflation rates experienced in the 1980's, there is apparently little faith in life insurance among the Macedonian public. The General Manager of Vardar mentioned that until 1988 that company had 40,000 life insurance policies, but the value of these policies was extinguished by high inflation rates. Development of this market is also constrained by prior problems of frozen foreign currency accounts, the low standard of living, and the lack of investments available for life insurance companies.

4. Pension Funds

RM has a compulsory pension system in place that provides pensions up to 80 percent of wages on the basis of years of service. This "first-pillar" system is financed on a pay-as-you-go basis. Although monthly payments to pensioners are being met, the system apparently has no reserves; payments to retirees are being financed by current contributions made by active workers. (Approximately four years ago there was apparently a problem meeting current obligations to retirees.) The rate of contribution to the system is 20 percent of wages. As the number of retirees grows in relation to the number of active workers, it will become increasingly difficult to finance current retirement benefits from current contributions. This problem will be exacerbated by economic problems, especially high unemployment, which reduces the amount of current contributions. As a result, the system is unsustainable without reform.

In response to this situation, a new pension system has been developed. It is based on the addition of a "second-pillar" plan complementing the first pillar, which will be reduced. The second pillar will consist of a defined contribution plan – mandatory for new workers entering the labor force – based on individual accounts comprised of each worker's contributions and investment earnings on them[62]. Under the two-pillar system, contributions to Pillar One will be reduced to 13 percent, while the remaining 7 percent will be contributed to the Pillar Two accounts. To control expenditures under the current system, the maximum replacement rate is being reduced to 72 percent, pension indexation is changing from 100 percent of wage growth to 80 percent price growth plus 20 percent wage growth, and retirement ages will increase to 64 for men and 62 for women.

Under the two-pillar system, the maximum Pillar One replacement rate will be reduced to 30 percent. The missing 42 percent will presumably be made up from the individual Pillar Two accounts, inclusive of investment earnings. Expected Pillar Two replacement rates depend on complex actuarial and economic projections. Under the new system, workers already covered under Pillar One will be given the opportunity to switch to the combined system. However, the maximum credit for Pillar One service will be five years of service. As a result, switching will not be favorable for most workers. The exceptions will be young workers with few years of service. In fact, one of the complications under the new system will be the determination, on a case-by-case basis, of whether switching is in an individual worker's interest.

As the new system grows, the Pillar Two pension funds will become major and ultimately dominant players in RM's capital markets. Pillar Two assets are expected ultimately to stabilize around 70 percent of GDP. The inflows of contributions will pose a significant problem in light of the relatively undeveloped status of RM's capital markets. Only one government bond issue is presently traded on the Macedonian Stock Exchange, and the volume of stocks traded is low. Because the build-up of capital in the Pillar Two pension funds will be gradual, it would be expected that new investment vehicles will be developed to handle the supply of funds.

As noted above, the system is currently unsustainable, and there is a fiscal need to move on with pension reform. While the issue of first pillar PAYG arrears is not viewed as severe, much of this is due to the issue of accounting. Records are not always accurate or up to date. Moreover, pension benefits paid were equivalent to $337 million over the first 11 months of 2001. Annualized, this would approximate $367.5 million, about 11.6 percent of estimated GDP, and 37.1 percent of total expenditure. Payments into the Fund showed a slight deficit of 495 million denars, or $8.1 million-equivalent on an annualized basis[63]. While the net deficit is not severe, pension reform is driven by the need for continued budget discipline, the risk of bad data obscuring the problem, and the need to put the pension system on a sustainable financial basis for the long term. Meanwhile, as has been observed recently in Poland (and elsewhere), the introduction of pension reform can serve as a useful catalyst in helping to develop capital markets. While there are many factors involved in this, having private pension fund managers will serve as an incentive for other forms of contractual savings.

62 See Patrick Wiese, "A Summary of the Macedonian Pension Reform: Policy Parameters, Forecasts, and Financing," June 15, 2000 for a helpful description of the reform, from which this paper draws.
63 540 million denars annualized/66.8 = $8.1 million.

C. Current Status of Arrears and Restructuring Costs

There are no figures to quantify the cost of recapitalization, restructuring and arrears in the banking system. In the case of the Stopanska privatization, the Government absorbed a gross cost of DM 235 million from the four major loss exposures. However, on a net basis, it received proceeds for its share sales of about DM 64 million. In terms of the other banks that were privatized, the sales were for small amounts. For example, Alpha acquired its majority stake in Kreditna for DM 15 million. The strategic investors in Tutunska agreed to pay DM 30 million. NBRM reported a total of DM 97.3 million in foreign investment (including sales) to recapitalize banks in 2000[64]. This likely offset a major portion of the cost of forbearance of the other banks that have implemented corrective actions to comply with increased capital requirements.

The largest cost that is quantifiable is in the form of the DM 1.1 million-equivalent in bonds issued by GoM as compensation to citizens for frozen foreign currency accounts. As there is no guarantee the Government will ever receive compensation from Belgrade for this, this is an explicit cost. The Government has agreed to pay 2 percent annualized per year on these bonds, and to amortize them in equal installments over a 10-year period. There is the possibility of early redemption of some of the value of the bonds, as people can use them at face value to pay down tax arrears, to acquire properties from the state, etc. Compensation from Belgrade plus the economic benefits of restored confidence and investment would offset some of these costs. However, for the moment, there is no guarantee of either.

It is likely that the largest cost to date has been in the form of enterprise arrears to banks and to other companies. One estimate is that inter-enterprise arrears approximated 36 billion denar (about $550 million) at March 30, 2001[65]. First, for banks, non-performing loans have been high on a continuous basis for years. Annex 1 includes a table that presents a rough estimate of impaired assets. If equivalent to real losses, this would approximate $1.5 billion, or 5.8 percent of GDP since 1995[66]. At a minimum, this has weakened bank capital, and now choked off credit due to the dubious credit worthiness of many/most companies given modern prudential requirements that insist on strict credit quality[67]. Second, for enterprises, inter-enterprise arrears have interrupted the supply, production, payment and distribution system. Such arrears (once persistent and long-term) inevitably drive up the costs of transactions, reduce the credit worthiness of firms, reduce their volume of purchases (for discounts) and inventories, add to inefficiency (particularly unit costs of production), require cash for business to move forward, and eventually lead to wage and other arrears that trigger epidemic levels of underemployment. Third, all of these problems put pressure on utilities that are public

64 See "Annual Report: 2000", National Bank of the Republic of Macedonia, March 2001.

65 The last reported estimates from ZPP.

66 $1,469 million/$25,419 million = 5.78 percent.

67 While there are reports and allegations that abuses continue, by and large, the largest banks are generally now private and mostly foreign-owned (apart from Komercijalna and Makedonska), and less likely to engage in traditional levels and forms of connected lending. Beyond that, the gradual professionalization of banking will improve standards. However, due in part to political instability, lending has been curtailed. This has slowed economic growth.

enterprises to provide subsidies (e.g., lower tariffs, barter, delinquencies, default) to enterprises that are encumbered by the trap of hard budget constraints imposed by banks combined with the loss of goodwill in the marketplace due to the build-up of inter-enterprise arrears. The impact of these developments in the form of poor credit quality, foregone transactions, lost fiscal revenue, higher borrowing costs, and other costs are likely equivalent to several percentage points of GDP each year, translating into significant per capita income losses.

An additional cost in the process has been reported to be corruption. While there is recognition of underlying honesty on the part of many individuals in countries across the globe, there is also recognition that corruption is a problem in government and public administration in many parts of the world. This has reportedly been the case in RM as well, and has been manifested in the form of cumbersome business registration procedures, court practices, licenses and permits, etc. This has added to the problem of lax corporate governance, tax compliance, and reliance on political patronage and connected lending for financial support. All of these problems are being addressed. However, they cannot be reversed overnight. This adds to continuing costs of transition and reform.

There may have been some additional offsetting factors to the arrears problem becoming worse than it became (as in the CIS countries). First, for all the inequities and problems, the previous ZPP system was efficient in tracking arrears, and blocking accounts when delinquencies occurred. In one sense, this reduced the arrears from enterprises on pension, health, tax, wage and other accounts. However, this also served as a catalyst for conducting affairs outside of formal institutions to avoid taxation. RM is faced with the challenge of restoring confidence after many years of bypassing formal authority[68]. Beyond that and as an extension of the ZPP issue, there is a high level of informal activity and cash in the system. This has been inefficient, yet has also served as a buffer against all of the problems associated with the breakdown of the former Yugoslavia. To the extent that significant activity and transactions have been carried out informally and through parallel structures, this has been done at no explicit direct cost to banks, enterprises and government. However, such activities tend to culminate in a major opportunity cost to the economy at large, undermining any comparative advantage that may exist when the system is formally galvanized. Based on all of the above, it appears that the cost has been substantial in terms of foregone GDP, incomes, employment, and other benefits associated with structure, certainty and confidence.

[68] This has been and is a challenge faced by all ex-Yugoslav countries, and a challenge in Yugoslavia today.

VII. General Outlook

Notwithstanding progress in the last two years, neither banks nor NBRM are yet prepared for some of the more complex risks that might eventually be assumed under more developed conditions. Fundamental credit risk remains the key risk for now, as about half of all income is interest income. Meanwhile, many of the problems that accrued in the past were off-balance sheet in the form of letters of credit, guarantees, and other items. These are basic credit risks that will need to be monitored. However, RM has an open current account, and people already move their money in and out of the country on a fairly open basis[69]. Such movements will need to be monitored for liquidity, interest rate, and foreign currency risk issues, as well as for criminal activities (e.g., money laundering). Likewise, over time as banks modernize, they are likely to be more active in fee-generating activities, including foreign exchange trading and capital markets activities. The supervisory authorities and SRO for the securities markets will need to ensure that capacity exists to manage the risks they assume. There is already widespread recognition of these risks, and the need to contain them[70]. This will also mean that the supervisors themselves will need to be kept up to date on instruments, techniques and transactions, as well as to have effective protocols in place for the exchange of information across borders among supervisory authorities to monitor international transactions that could potentially be destabilizing to the economy and financial system.
For the moment, there are still several weaknesses and challenges that could undermine stability. These are briefly summarized below.

- The *general environment for risk-taking* will likely remain weak for the foreseeable future. While many new laws have been adopted or are in the process, including several that relate to secured transactions[71], it will take time for institutional capacity to develop and demonstrate that secured assets are adequately protected. Until then, banks will be less likely to assume traditional risk, which will limit the amount of lending that banks will be willing to provide. In the absence of other financial services, this will remain an impediment to economic development in RM. Likewise; inadequate and incomplete information through formal accounting channels will also stifle development of a meaningful institutional investor market. While many complain that there are sound companies and projects that can be funded, there is reluctance by banks and others to take on risky exposures. The lack of adequate information and business planning may be one of the key structural impediments.

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69 RM liberalized its current account fully in 1998. Meanwhile, capital account transactions are subject to few restrictions.

70 See www.nbrm.gov.mk, www.finance.gov.mk, and www.sec.gov.mk .

71 These include a new Bankruptcy Law, and a new Law on Pledges.

- The *political environment* reinforces the premium on risk-taking, interferes with medium- and long-term planning, causes enormous inconvenience and volatility, and makes it difficult to implement reforms. RM has done much to introduce an adequate framework for growth while maintaining respectable macroeconomic fundamentals regarding inflation rates, fiscal balance, and exchange rate stability. However, the political divisions that permeate RM make it difficult for many businesses to invest for long-term growth. Instead, the uncertainty (that is reinforced by past shocks) reinforces a short-term, cash-oriented economy. In the long run, this stifles growth and institutional development.

- *Capital* remains low and is unlikely to grow substantially. While 8 percent minimum CARs will help (as long as they are observed), it does not appear that aggregate capital will grow substantially for quite a while. This is because the market remains relatively small, earnings are largely generated from interest income (which is limited), there is a relatively small corporate sector that is viewed as credit worthy, and there is virtually no active securities market or serious institutional investor interest in the banking sector. The recent investment by Greek and Slovene institutions into banks likely points to RM's best hopes for subsequent direct investment and increased trade flows with the Euro-zone. However, to date, these investments have been relatively small by global standards.

- *Asset quality* has been a problem for years, as shown in high levels of non-performing loans. This has weakened earnings, and brought the banking system to low levels of solvency in the past. Asset quality could be undermined in the future if there is undue pressure on banks to lend. Weak accounting standards in the real sector make this more challenging for the banks. Recent legislation to strengthen creditors' rights may help, but this also depends on consistent judicial rulings. As of now, the courts are entering a new period in which they hear cases and rule based on new legislation. However, even with that legislation, if the courts show their traditional debtor bias and/or are vulnerable to reported corruption, this will perpetuate the banks' aversion to the use of the courts, and to riskier lending portfolios. Asset quality has also been weakened by the MEBO bias or privatization methods, which entrench management and generally translate into weak and unqualified board oversight of management performance. As has been shown elsewhere, it is not enough to transform ownership classification (from state-owned to private). Unless proper governance, management, discipline, disclosure and skills are also in place, the commercial viability of a project and its management is risky. However, there is often pressure on banks to lend even when borrowers and projects fail on tests of commercial viability, capital structure, cash management, and other fundamentals of prudent lending. Rather than forcing banks to lend, the onus should really be on the enterprise to demonstrate its ability to manage cash and risk. But if pressure to lend is firm, there is a higher probability that funds will flow to non-viable enterprises and/or projects.

- Movement towards privatization in the financial sector and the economy has led to the introduction of new incentives for improved *governance and management*. There are reports that new standards are being introduced with the presence of strategic investors. Given the difficulties faced in 2001, banks have not had an ideal environment in which to operate, and changes frequently take two to three years for new bank systems, procedures and controls to be in place before active market expansion takes place. It remains to be seen how management will fare as banks assume greater balance sheet exposure over time. As found in other markets, not all strategic investors succeed in transition economies. Nor do they all remain in these economies when competition intensifies. However, as RM banks' strategic investment is largely from regional partners, the prospects are better that they will remain committed to their investment in RM banks.

- *Earnings* will be subject to the challenge of a small market, a culture of default, and the risk of adverse selection to compensate for a small volume of earning assets. There has been little development of more lucrative services, although gradual introduction of new electronic services and cards should eventually lead to increased use of banks by households and enterprises. This should also increase the share of fee income in banks' overall earnings. However, most critical for banks will be management of fundamental credit risk. This weakness has been the major source of foregone earnings and weak capital of banks.

- As the NBRM moves to a more open market basis for the implementation of monetary policy, banks will need to demonstrate their ability to manage *interest rate and exchange rate risk.* Along with adequate *matching strategies for maturities*, this should not be hard to achieve as they represent core preconditions for successful banking. However, along with *pricing risk*, this has often caused major losses in advanced institutions. Thus, there will be constant risk that sharp movements could materially impact the relatively small portfolios of Macedonian banks. This occurred in 2001 when hostilities broke out, and the NBRM defended the exchange rate. The response was to increase compulsory reserves and to hike interest rates dramatically. This had a major effect on many banks' liquidity positions.

- The *payment and settlements system* has recently undergone changes, with the introduction of RTGS and a new bank-owned clearinghouse for small-value payments. Few problems have been reported for the large value system. However, there are reported to be problems with banks' interface systems, as they all generally developed their own systems internally. This slows processing time, adding to delays and inefficiency.

- There is a high level of *concentration in the market*, with Stopanska and Komercijalna accounting for a very dominant deposit market share position among households and enterprises. This could pose a risk to other institutions' funding and liquidity. Should either or both banks have a problem, this could clearly become systemic. In particular, Komercijalna will need to be monitored due to its diluted and predominantly domestic shareholder structure. In the future, predominance in the T-bill and inter-bank market could subject the market to liquidity problems, particularly if any of these banks faces serious erosion in portfolio quality.

- *Savings associations, credit unions and micro-finance groups* are generally pretty small in terms of financial measures (e.g., loans, deposits). However, in some cases, they represent possible targets for pyramid schemes or other kinds of criminal activity. Such activities will need to be monitored, particularly if any of these groups were to offer extraordinarily high rates on deposits, or to process payments that were criminal. Recent developments in Romania show that there are risks to unregulated channels for deposit-taking that can cause panic, damage confidence, and require central bank intervention. Albania's history with pyramid schemes also serves as an example of what needs to be monitored and avoided. Such risks are not only in the banking sector, but also potentially in the insurance sector.

- Since 1999, efforts have been made to contain risk-taking behavior and to hold management accountable for prudent standards. With about 70 percent of year-end deposits in foreign currency, RM remains sensitive to developments in the Euro-zone. It is uncertain if interest rates in neighboring countries have much effect on RM. They should in Greece, given the role of Greek investors in banking and other major sectors of the economy (e.g., cement, telecommunications). On the other hand, events in Turkey appear to have had little effect on internal developments. There are reported to still be major holdings of foreign currency outside formal channels, notwithstanding the recent surge in deposits in December 2001. Should these funds find their way to the formal system, local interest rates would presumably be affected. As RM has an open economic system, *market risk* appears to be a mix of internal and external factors, with political instability probably the key risk for now. Reserves are less than four months' import cover, and any resumption of hostilities might trigger a decline in such reserves for war-related expenditure. As shown in 2001, interest rates fluctuated significantly as NBRM defended the currency. Meanwhile, even under stable conditions, RM will be vulnerable to movements and developments offshore (e.g., future slow down of the EU economies). In the future, if remittances/transfers are eventually channeled into more formal capital markets opportunities on the local securities market, RM would need to closely monitor the potential for rapid outflows.

VIII. General Strategies and Options

Efforts in recent years (since 1999) to develop financial markets have focused on new legislation and regulations, strengthening banking supervision, using the local exchange for Government bonds and securities, introducing supervisory oversight in insurance and reforming the pension system, strengthening registries (for pledges, premises, and shares), and moving to more efficient payment and settlement systems. RM efforts to stimulate increased competition and better bank management have led to the attraction of strategic investment in several banks, including from two major Greek banks. In 2000, several trends appeared favorable.

However, as has occurred in some of the successful transition economies (and advanced countries that have periodically faced a banking crisis[72]), monetary means are sometimes utilized to recapitalize balance sheets. This generally comes in the form of banks maintaining high real net spreads to boost interest margins, and investing in government paper for safe returns and easier attainment of regulatory capital requirements. However, it imposes financial challenges on the real sector in the form of limited credit access, shorter maturities, and high costs, including on enterprises that are well-managed, profitable, credit worthy and efficient. This has occurred in RM, where new credit flows have been limited. Moreover, a cautious approach to lending has been reinforced by years of non-performing loans, uncertainty about collecting on pledged assets in the event of default, tougher prudential norms, and weak capacity in the real sector with regard to accounting standards, financial management, market research and business planning.

In the end, what has happened in RM and many other transition countries (including in CIS countries and several countries in the Balkans) has been continued reliance on informal sources of finance by households and, to some degree, enterprises. This has made it difficult for banks to build a viable funding base, particularly given the freezing of accounts earlier in the 1990s, and the uncertainty resulting from the refugee crisis in 1999 and the political crisis in 2001. The weak funding base keeps the supply of credit low and pricing high if done on a commercial basis. In the past, the Government frequently stepped in to subsidize, absorb losses, or to direct credit. However, this practice has been largely discontinued (with some reported exceptions) due to the high proportion of non-performing loans and weak earnings that still characterize the banks. Thus, building a system where incentives point the real sector to non-bank and informal channels is where

[72] Examples include the United States *after* the Savings and Loan crisis that, according to the FDIC, cost taxpayers more than US$100 billion. When many banks faced problems after the savings and loan crisis—assets of failed banks in the U.S. from 1980-94 were US$206 billion—they scaled down lending, increased spreads (partly by suppressing deposit rates), and increased investments in government securities. All of this helped to recapitalize the banks, which then made it possible for the Federal Reserve Bank to eventually ease monetary policy. Rather than provide explicit fiscal injections that taxpayers would view as another bank bailout, monetary means were used to recapitalize bank balance sheets and restore soundness. See "History of the Eighties: Lessons for the Future," U.S. Federal Deposit Insurance Corporation, 1997.

much of the dilemma originates. Transforming incentives in a manner that is commercially sustainable is required to reverse this pattern, and this is a time-consuming process.

A major challenge is how to encourage banks to lend to credit worthy enterprises. In RM, the enterprise sector has done poorly, although this has been partly due to the shocks that the sector has had to face for the last decade. There are reported to be SMEs that are credit worthy, and this trend is likely to continue into the future as new businesses adapt to more modern management techniques, reduce cost structures, respond more quickly to market opportunities, and conduct more systematic market research. However, these loans are more costly to process from an administrative standpoint, and financial information is often weak from these firms. For the foreseeable future, it is not likely that there will be heated competition for lending to RM's corporate sector of the sort that would put downward pressure on rates.

A second challenge is how to trigger a push by competing banks into expanded retail operations. Recent trends have shown increasing deposits from households. It is also likely that many of the kinds of businesses that will employ people and help the economy grow over time will be companies that are relatively small. These are often the kinds of companies that would benefit from banks' retail operations, as they provide fundamental services that are appropriately scaled to SME needs. However, if deposits flee the system, this will provide the banks with less incentive to push into retail activity and consumer finance. Moreover, for banks to be able to provide these kinds of products efficiently, they will have to invest in ATMs, introduce debit and credit cards, explore the feasibility of cross-selling (e.g., securities, pension, insurance, mortgages), and have capacity and systems to manage related risk. Some of this is already happening, albeit on a limited basis. Such investment also means banks will have to assume high costs in terms of hiring and personnel training, introduction of larger information systems, and expansion of a branch network. Again, some of this is happening, particularly with the new bank-owned clearinghouse system for small value payments. However, most banks are niche players, and retail banking has not really developed. RM will be a more feasible market for retail banking development when per capita incomes show steady improvement, when trade and investment increase considerably to levels that are judged to be sustainable for the foreseeable future, and when MNC exporters begin to use more local companies as suppliers for cost/productivity purposes. However, in RM, where per capita incomes are about \$5,027 on a PPP basis[73], making a major investment in a branch network (even wireless) is often rejected as uneconomical or inopportune. This is heavily influenced by political instability in the country, and weak earnings.

Other key challenges loom on the horizon. Restoring confidence has been difficult, although there was some evidence in 2000 of favorable deposit mobilization trends, a sign of confidence. Such confidence is not just related to banking, but also affects other resource allocation decisions. It is unfortunate that only one RM enterprise actively trades on the MSE, and that other firms (traded on the other markets or completely off-market) have not listed. Likewise, insurance is underdeveloped,

[73] Figures are from the World Bank.

the pension system is still PAYG (although changes are in the making), term finance is generally absent from banks and other sources for project finance or mortgages, leasing is virtually non-existent, and municipal finance is broadly underdeveloped.

To strengthen the banking sector and generate meaningful standards of intermediation, several actions can be taken. These are all relevant to banking sector development, and broadly relevant for non-banks as well.

- As a goal to be sustained perpetually, RM should ensure that *investments in Government securities are safe and secure* as an investment destination, particularly given the existing resource flows from banks, the introduction of the state-owned deposit insurance fund, and the predominance of Government securities on the MSE. While this is axiomatic as a building block for financial sector development, it is not to be blindly assumed. Moreover, it is essential for maintaining public confidence, which will be essential in subsequent years for private contractual savings products.

- RM should continue with its efforts *to adhere to international norms and become members of international organizations.* Legislation and regulatory structures have clearly been based on BIS, IOSCO and IAIS core principles. The key challenge now is to introduce the practical working mechanisms for effective implementation. In banking, this includes strengthening capacity to monitor for market risk, and general risk management on a consolidated basis.

- In keeping with efforts to strengthen the institutional environment, *judicial reform* should include a comprehensive program to train judges and other court officers in bankruptcy and secured transactions (based on new legislation). This is already happening to some degree with efforts to strengthen judicial capacity. However, given the amount of time required to develop a well functioning judiciary, RM should consider (i) a new approach to court organization and administration, (ii) upgrading the professional skills of judges, bailiffs and lawyers in commercial law, (iii) making the judiciary more independent, (iv) curtailing many of the courts' administrative functions to facilitate better time and caseload management, and (v) improving systems so that information is more readily available and electronic (e.g., access to pledge registry, immovables, ownership in companies and banks). GoM should also consider the use of specialized commercial courts for large bankruptcy and secured transactions, as well as the use of out-of-court mediation and arbitration to resolve lower value disputes in commercial cases. Other courts might specialize in financial fraud and money laundering. Under current circumstances, the courts can potentially be vulnerable to corruption and inefficiency due to ambiguous laws, a bureaucratic and administrative orientation, manual processing, and low pay.

- *RM needs to develop a suitable audit and accounting profession* for the development and maintenance of standards, particularly as they apply to the enterprise sector. IAS and ISA are necessary prerequisites for firm-specific information. All of this should be within the framework of a broad effort to adhere to international standards, and to develop the accounting and audit professions accordingly. To date, banks have been required to use IAS. However, this affects only a small fraction of the real sector. Efforts should be made to focus on accounting and audit as business tools for management and planning, as well as the basis for better financial information flows.

- From a regulatory standpoint, *savings and credit institutions* should be encouraged to develop as a complement of and potential link to the banking system. This is currently under way, as RM has 19 savings houses, including a strongly performing micro-finance operation and a nascent credit union movement, both of which are currently licensed as savings houses. Banking supervision regulates the savings houses and monitors their resource flows and performance. In particular, NBRM needs to ensure that these institutions are not misused or undermine financial sector stability, such as by promising to pay very high interest rates on deposits or other practices reminiscent of pyramid schemes[74]. Other countries have shown that this is a risk even after a major crisis occurs and is subsequently resolved[75]. However, with proper management, these kinds of institutions can also help to provide safekeeping, lending and other services to communities that are frequently neglected by banks due to their poverty, isolation, or generally small scale of resources and operations.

- Building blocks for *improved corporate governance* would include protection of minority shareholder investment, and stiffening qualifications for Board members. The new Companies Law being drafted should provide better standards. However, having qualified board members will remain a challenge for the foreseeable future with regard to capacity to conduct a proper assessment of proposed strategic plans, and proper oversight of management performance relative to accepted plans. The emerging importance of the internal audit function and Audit Committee can and should be used to monitor how companies manage resources and report to shareholders. An organizational and informational prerequisite for this is adequate MIS to ensure the information generated is timely, reliable and accurate. There is also the issue of the autonomy of the internal audit function, and whether there is an internal mandate provided by boards to ensure that internal auditors have sufficient autonomy and are empowered to report problems or violations. For banks, it is now required through legislation. There should be comparable requirements for larger companies, and real sector requirements should parallel requirements in financial institutions for reasons of accountability and integrity. This should also be a prerequisite for firms that want bank loans above certain levels, or want to list on the

[74] Many countries in the region have encountered problems with pyramid schemes. The collapse of these schemes in Albania and Romania caused major damage to public confidence and private savings.

[75] Romania experienced problems earlier in the 1990s with pyramid schemes, and only recently began to bring "popular" cooperative banks under the regulatory umbrella of the central bank. Many of these mini-banks were offering rates on deposits that were far higher than those offered by the commercial banks, presenting the potential risk of collapse and panic in the banking system.

Exchange. These should be high-level priorities of the banking supervision department, beginning with licensing procedures and carried forward through regular off-site surveillance and on-site inspections. Likewise, such issues should be areas of focus for regulators in the securities, insurance and pension markets.

- In conjunction with tougher requirements on board members, *management* should be required to demonstrate the ability to come up with reasonable strategic plans and to implement. The banking system is expected to become more competitive and open. Meanwhile, as fiscal pressure diminishes, it can be projected that investment in securities will diminish over time as a proportion of total credit exposure. This would require that banks then assume and manage increasing levels of credit risk as a basis for generating earnings, boosting capital, and expanding operations. As part of modern management, proper compensation and performance incentives will need to be structured and put in place to reward management and employees.

- In general, NBRM will need to be sure that banks have proper *risk management systems* in place. This has already been adopted in legislation as a requirement, and banks are now introducing risk management systems. BSD will need to be able to keep up with these systems as banks become more complex.

- Efforts to *modernize the payment and settlement system* have begun. However, banks might want to consider harmonizing the software they use for the SVP system. Until that happens, it is likely that clearinghouse activities will be slower than they should be. This may also take away from some of the benefits that would otherwise benefit banks with regard to liquidity management and earnings, as they may have to keep more funds available for transactions due to uncertainties associated with slower processing.

- There should be consideration towards development of a more comprehensive *credit information bureau* to serve as an incentive for demonstrating and documenting sound credit performance. A system exists at NBRM to track credit exposures of banks. However, there is significant problem debt in the system outside the banks, mostly in the form of inter-enterprise arrears and arrears to electricity, heating and other utilities. A more comprehensive and accessible system should track performance of credit exposures, with clear identification of companies, their owners, and subsequent companies established. The last point and the link to individuals who are owners or represent controlling interests is essential in reducing the incidence of lending to owners/managers whose track record is one of continued failure (e.g., bankruptcy) and default. Such a database would provide prospective creditors (including non-bank institutions such as commercial finance, leasing, mortgage finance and other creditors) with more valuable information on the aging of credit, whether it is from banks, suppliers, utilities companies, Government funds, or other sources. This would be a key function of both regulatory as well as market-based oversight. It would also provide an initial basis for smaller or micro firms to have more cogent evidence of credit worthiness as they grow and move on to the banks, leasing companies, or securities markets for financing.

- As an extension of the credit bureau (see above), donors and others should assist with efforts to *establish a documented track record at the micro-enterprise and SME level* of financing to serve as the basis for "graduating" to the banking sector when financing demands reach those levels. The key here would be to ensure the veracity and standards of such a documented credit performance database to assist enterprises in convincing banks of their credit worthiness once their financing demands exceed the capacity of donor-assisted projects, and once banks are in a position to increase lending.

- Eventually, *mortgage finance* could emerge as a major catalyst for banking, securities and contractual savings, as well as a destination for government funds. However, this will take time to develop. On the positive side, there is a long tradition of private property ownership in RM, and issues of ownership rights, title, and the transfer of title do not appear to be problematic on the condition that all documentation is registered with the courts. There is some real estate activity in RM (about 3 percent of 2000 GDP), including some initial lending for residential properties (e.g., flats, detached homes). However, most transactions tend to be private and cash-based. Banks currently have little appetite to lend into this market given the long-term nature of the financing. While there is a long tradition of private residential ownership that makes these prospects more feasible, there is no known commercial property financing, and it is possible that some of the judicial reforms currently in process will need to be fully implemented and tested before the market will take long-term property risk. Meanwhile, the insurance sector will need to refine property and casualty practices and procedures to make this feasible. In addition, for mortgage finance to increase, banks will need to obtain clear title to properties before contemplating a major increase in lending, or the issuance of mortgage bonds. The former appears to be feasible, but the latter will require time for inventory build-up and development of syndication outlets. Better information for valuations will be needed for banks to assign loan-to-value ratios, particularly if the current limited activity starts to become more competitive. Fundamental services will also be required (e.g., land use planning, site management) for both residential and commercial properties.

- These same issues will also apply to development of a *municipal bond market.* While the new power sharing agreement calls for administrative decentralization or municipalization, a large number of preconditions need to be in place for municipal bond markets to emerge. More than anything, municipalities will need to establish a viable tax base as their proof of credit worthiness. Given the weak tax base that exists currently, this will take time to develop. Other institutional requirements will be the need for credit ratings, adequate disclosure of information to attract investors, and capacity at the MSE to handle the bonds. The last point is available, but the other two conditions and everything associated with municipal management, budgeting and planning are currently absent.

- *Leasing* sector development has been slow to develop, largely due to banks' focus on strengthening capital. Given existing prudential norms, banks are only permitted to have fixed assets up to the value of capital. This reduces their ability to obtain assets for lease purposes.

- To the extent that *factoring* and *commercial finance* operations emerge, they should be encouraged. However, as risk-takers, their operations should not be permitted to undermine deposit safety. This would mean banks active in these fields would be subject to prudential regulations governing these activities as part of the overall credit risk management function, or that non-banks would not be able to mobilize deposits or access any deposit insurance coverage from the Deposit Insurance Fund. In the latter case, this would require an active communications and education campaign to ensure the public is not misled.

All of the above are relevant for non-bank financial sector development, particularly as RM evolves towards the universal banking model long established in continental Europe. At a minimum, even if the universal model is not followed for many years to come, banks and non-banks will be linked in activities and risk exposures.

Table 9: General Parameters for Financial Sector Reform in the Republic of Macedonia

Issues	Current Status	Recommendations/Objectives
Legal		
Secured transactions	New bankruptcy and collateral legislation in place, but generally untested in courts	Enforce with a strong creditor bias; seek to shift system to a precedent-based system; consider the use of specialized bankruptcy courts
Property registries	New centralized pledge and immoveable asset registries became effective in December 2001	Permit easy public access; efficiency in updating can be achieved with electronic links between local points of registration and official documentation, and central systems
Judicial capacity	Preliminary plans for training and court organization; judges still adapting to steady stream of new legislation	Demonstrate fairness and efficiency based on familiarity with modern commercial norms; introduce specialized commercial courts for bankruptcy, credit disputes

Table 9: Continued

Issues	**Current Status**	**Recommendations/Objectives**
Out-of-court resolution mechanisms	Lack of experience through formal mechanisms; in practice, banks and others seek to work out contract disputes privately due to the time and money costs (and to avoid reported corruption) of in-court processes	Introduce non-court arbitration for relatively small value transactions; utilize in conjunction with international institutions for large transactions when contract disputes emerge and conflicting parties voluntarily opt for this mechanism instead of in-court procedures
Regulatory		
Information and statistics	Significant improvement in availability of information; many good web sites reflect efforts to adhere to sound standards of transparency; however, data for the real sector and broader market research purposes is lacking; quality of data often suspect or incomplete	Need to improve the quality of information in the real sector at the firm level, as well as for broader market purposes; absence of disclosure, weak accounting, and ineffective trade associations undermine information flows and market development
Banking supervision mandate	Clear mandate to supervise; well trained personnel; weaknesses remain with regard to consolidated supervision, market risk, risk management, largely due to lack of experience with complex institutions	Work to strengthen market risk, consolidated supervision capacity; reports of continued government involvement in some banks make it difficult to enforce mandate evenly
Securities market oversight	SEC and MSE in place; laws and regulations generally satisfactory, but compliance with IOSCO standards not achieved, and market practices (e.g., Third Market) generally criticized for bad governance, manipulation, and non-transparency	Limited activity on the First Market; most trading in shares done without adequate disclosure; work with IOSCO to enforce basic standards, work towards introducing portfolio investment (including channeling remittances, etc) to stimulate investor interest; leverage off of Government securities and pension reform to serve as catalyst for market development

Table 9: Continued

Issues	Current Status	Recommendations/Objectives
Pension fund oversight	Legislation pending in Parliament; enactment expected in early 2002	Establish capacity to monitor funds' investments, management, information disclosure and systems for consumer protection
Insurance oversight	Agency established with strong leadership; thin market, limited experience and small staff require additional training and assistance	Need better statistics and data for actuarials, broader acceptance by firms of need for insurance; need enhanced capacity for adequate supervision once market begins to grow
Infrastructure		
Payment and Settlement Systems	RTGS and bank-owned clearinghouse in place	Banks need to harmonize software for faster processing and clearing; consolidation of many smaller banks would help with SVP coverage for customers, although any push in this direction should be market-based (as there are low-cost methods of expanding market presence)
Securities market framework	Little activity; 70 percent Government securities	Need to strengthen outreach to companies to increase listings; need to improve business plans and financial information to attract investor interest; need to assess communications strategy; need to promote adequate information to encourage listings and capital formation
Insurance framework	Little activity to date, and high level of concentration	Need to strengthen regulatory and supervisory capacity; support efforts to expand market coverage
Pension fund framework	No funds established yet	Work with IFIs/EU to ensure viable privately-managed pension funds with sound fiduciary and custodial capacity with implementation of the second pillar; develop supervisory and regulatory capacity
Accounting/Audit Capacity and Standards	Weak domestic capacity	Training to achieve IAS/ISA, particularly in the enterprise sector; need for better understanding of the use of accounting and financial disclosure for management and financing, rather than traditional tax-related purposes and formalities

Table 9: Continued

Issues	Current Status	Recommendations/Objectives
Credit Information	Bureau exists at NBRM for exposures to banks; no system available for non-banks	Support development of a more comprehensive database to track arrears and problem credits to all formal creditors (e.g., power companies, Government accounts and funds, enterprises), not just banks; support broader understanding of positive and negative incentives of information disclosure and its importance in obtaining debt and equity financing
Rating Agencies	None exist	Continue to inform public of reform progress, with goal of eventually attracting ratings for institutions and securities
Competition		
Banking	Still high concentration, but enough foreign and private banks to have competition; continued use of some banks for political purposes, although much reduced	Government should exit completely; reinforce measures to build confidence in safekeeping capacity of banks; cease using Government deposits and other resources to influence lending decisions; eliminate use of banks for patronage purposes; encourage professionalization standards to enhance corporate governance, qualified boards at all banks
Credit unions	Some activity via WOCCU; limited capacity to mobilize deposits, make loans; legal constraints to operations	Ensure sound record-keeping and documentation; seek to graduate good businesses to banks on strength of cumulative credit performance; consider back-up line of credit to increase lending as catalyst for mobilizing deposits
Savings houses	19 savings houses account for >6 percent of household deposits; poor reputation, and denar-based while most people save in hard currencies	Continue to monitor for safety and soundness; consider higher minimum capital requirements (or consolidation with banks) once all major towns in RM have at least three full-license bank branches

Table 9: Continued

Issues	Current Status	Recommendations/Objectives
Micro-finance	Several groups; Moznosti seeking bank license	Ensure sound record-keeping and documentation; seek to graduate good businesses to banks on strength of cumulative credit performance; encourage syndication upward to banks
Securities markets	Little market activity; Government bonds and auctions represent the main activity; possible introduction of OTC despite little market turnover and capitalization	Seek to activate the equity markets as base of financing for medium-sized companies; encourage establishment of active investment funds to exercise governance on mid-sized firms, with suitable disclosure requirements; consider support for closed-end fund for listing on First Market as a vehicle for attracting investment
Insurance sector	Four companies currently competing, with high level of concentration in currently small market	Seek to ensure solvent and reliable insurance companies that provide reliable, essential forms of coverage for businesses and individuals; bolster the regulatory system and supervisory capacity
Pension funds	Private funds will emerge for second pillar	Support implementation of the second pillar; support development of pension fund oversight with adequate training and education; ensure safety and security of pension accounts, including ability to assess custodial capacity to ensure sound standards and practices are adhered to; promote development of sound investment vehicles
Leasing	One company, no real activity	Encourage development of the sector; monitor bank exposures to private leasing companies to ensure bank CARs are not overstated; consider easing the 1:1 fixed asset to capital ratio requirement once banks demonstrate capacity to increase investment in fixed assets and assume more risk

Table 9: Continued

Issues	Current Status	Recommendations/Objectives
Mortgage finance	Only one bank reported to make a few loans; most property transactions done privately in cash	Seek to establish the needed infrastructure and institutions that would culminate in mortgage lending, followed eventually by mortgage bonds or securitization; link these efforts to municipal government activities (e.g., land use planning, property tax assessments, public-private provision of needed services)
Municipal bonds	None	Seek to establish the conditions for mortgage bond issuance to be feasible, including clear central-municipal tax powers, transfer arrangements, professional standards of budget management, and development of a viable fiscal base at the municipal level

IX. Specific Recommendations

A. Introduction

The following recommendations are presented to USAID as the key areas on which the team believes bilateral assistance should focus in the coming years. The recommendations were originally structured in four groups to provide strategic cohesion for USAID project implementation (essentially Recommendations 1, 9, 10 and 11). However, the team subsequently opted to present sub-sector recommendations as well as these more specifically emanate from findings of the members' assessments. The latter group includes Recommendations 2-8. Each of the recommendations is summarized below, along with potential benefits and risks, and links to specific aspects of USAID's strategic plan for FY 2001-2004.

B. Linkage to USAID Private Sector Strategy

In all cases, recommendations converge to support USAID strategic objectives for accelerated development and growth of the private sector. Specifically, these recommendations would strengthen bank and non-bank financial institutions (IR 1.3.1). The specific recommendations are focused on USAID's broader objective of helping to strengthen the economy to create productive and sustainable employment. While the financial sector itself is not a major employer in terms of head count, its ability to provide credit, investment *and* financial advice and discipline represent a needed resource catalyst for employment-generating capacity in the real sector. Hence, the recommendations mapped out below would reinforce USAID's strategy to have financial institutions willing and able to lend to firms (IR 1.3.1.1), viable, accessible and transparent equity markets (IR 1.3.1.2), and enhanced investor confidence (IR 1.3.1.3).

In addition to directly supporting USAID efforts to strengthen bank and non-bank financial institutions (IR 1.3.1), many of the recommendations overlap with and reinforce other USAID objectives in support of private sector growth. Financial sector recommendations would serve to enhance prospects for a more competitive, employment-generating, formally registered private sector (IR 1.3.2). Likewise, financial sector recommendations would create a more conducive business environment for increased investment (IR 1.3.3). The recommendations below also delineate how each would help to reinforce USAID's other efforts to promote competitiveness (IR 1.3.2) and an improved environment for investment (IR 1.3.3).

C. Proposed Recommendations

Recommendation # 1.

Maintain a Consistent Focus on Architecture, Infrastructure and Stability Issues
Description: A sound and stable framework for lending and investment is a precondition for

general market development. There are still many missing pieces in the architecture of RM's financial sector that are required for market development. In some cases, much of the foregone progress to date has been as a result of the numerous shocks and disputes that have hampered RM's efforts. However, it is still premature for certain kinds of markets or instruments to develop, even if the political environment were stable. For example, it is impossible to introduce mortgage-backed securities in the absence adequate valuation and appraisal standards, credit ratings, institutional investors and special trusts, adequate inventory of mortgage loans that could be packaged, clarity on the rights and obligations of debtors once a syndication market emerges, etc. Likewise, it is impossible to introduce municipal bonds in the absence of viable municipal tax bases, budget and management capacity, institutional investors, credit (bond) ratings, etc. Consequently, more work needs to be done to move the system forward so that it fosters confidence and competition without experiencing major volatility or managerial/supervisory debacles. General efforts in this direction should include (i) reinforcement of bank supervision, particularly as banking becomes more universal, and issues of risk management systems, consolidated supervision, and general market risk become more prominent; (ii) assistance to the SEC, Insurance Supervisory Agency and the new Pension Supervision Agency to ensure they have adequate oversight capacity for sound licensing of firms and funds, that these firms/funds have competent boards and management, that investment guidelines are complied with, financial disclosure and consumer protection are enforced, information flows are timely and accurate, and industry information flows to the public; (iii) establishment of a credit information bureau to track delinquent debtors in a manner that contains future credit exposure to target individuals, managers, owners and related firms; and (iv) at a later date, encourage establishment of credit rating agencies to provide a framework for investors to assess the fundamentals of firms and securities. Many of these and other specific sub-sectoral initiatives that warrant support are noted below in subsequent recommendations.
Benefits: In general, movement in this direction should provide ample opportunity to build a stable and sound framework for financial sector development. While the proposals enumerated below and incorporated within this broad objective are numerous and ambitious, in many ways they are preconditions for a competitive, viable, and diversified financial sector.
Risks: The major risk is time and resource requirements. Many of the recommendations require years of assistance, training and implementation. Should progress be slow, this can perpetuate many of the constraints and weaknesses that are embedded in the system. There is also a need to coordinate and harmonize so that market development is consistent and not working at cross-purposes. This overall recommendation assumes more than just USAID involvement, and its success is dependent on coordination with international and bilateral organizations, regulatory and supervisory institutions, and private institutions as they emerge.
Linkage to USAID IR 1.3.1: This recommendation and the sub-sectoral recommendations that follow (see Recommendations #2-8) constitute building blocks for increased willingness and capacity to make loans (IR 1.3.1.1), to stimulate transparent equity market development (IR 1.3.1.2), and to enhance investor confidence (IR 1.3.1.3). Failure to move forward on these options will likely impede progress, reduce confidence, and limit lender and investor willingness to take risk.

Linkage to USAID IR 1.3.2: Financial sector recommendations would provide direct opportunities to establish standards and vehicles for better private sector proposals (IR 1.3.2.1). The combination of legal, regulatory and institutional incentives focused on underlying stability would serve as a catalyst for firms to operate on sound business management practices (IR 1.3.2.2). Information requirements and enhanced risk evaluation capacity in financial institutions would also serve as a catalyst for firms to register, properly account and disclose information, and thus pay an equitable share of taxes (IR 1.3.2.3) to avoid issues of liability.
Linkage to USAID IR 1.3.3: The proposed recommendations would also reinforce USAID efforts to strengthen the business environment for investment IR 1.3.3 and IR 1.3.3.3). This is particularly the case with regard to the drafting of commercial laws and implementing regulations (IR 1.3.3.1), and in the process to advocate legal and policy positions (IR 1.3.3.4). Training and professional development in a number of areas also would contribute to business skills development in the labor force (IR 1.3.3.5), such as accounting.

Recommendation # 2.

Continue to Support Movement Towards a Competitive and Well-Governed Banking System
Description: Private ownership is viewed as a necessary condition for viable commercial banking. In this regard, RM has fulfilled this objective almost wholly, as there is only one publicly owned bank. However, the system is still lacking in competitiveness, and there are reported weaknesses with regard to corporate governance. This weakness has been reportedly due to the influence wielded by the central Government with regard to the placement of its deposits in various banks along non-commercial lines, and the use of such deposits to influence credit and other decisions made at some banks. Such patronage is frequently harmful to the normal functioning of a competitive banking system, and often leads to a deterioration of portfolio quality. In RM, hard budget constraints have been imposed on such kinds of behavior, containing much of the earlier damage done from directed lending patterns. However, in some cases, these problems have been transferred outside the banks to/through other non-bank creditors, with some of the same problems affecting the economy and real sector in the form of built-up arrears. Moreover, there are considerable weaknesses with regard to the quality and timeliness of information presented to banks in the formation of their credit decisions. All of this can undermine credit quality, spread risk through the system, reduce the quality of assets and earnings, and make it difficult for the banking system to become commercially viable. Specific assistance might consider the following initiatives: • <u>Encourage complete exit of Government from the banking system</u>. Apart from the Macedonian Development Bank, there is no explicitly state-owned bank. Moreover, MDB has restrictions regarding lending to Government. However, there are reports of continued use of the banking system for patronage, and of manipulation through the use of Government deposits (which increased in 2001). Such practices should cease. • <u>Support training, technical assistance and legal reform efforts to professionalize banking standards, enhance corporate governance, and have qualified boards at all banks</u>. In addition to general efforts to promote professionalization and ethics, assistance might consider efforts to develop "executive management" courses and certification that would enhance the capacity of board members to conduct sound internal oversight of management performance. The presence of strategic investors in some banks helps. Making this a more universal standard would contribute to systemic stability and soundness. Likewise, changing the information disclosure rules to be stricter with regard to shareholders owning less than 10 percent of banks would provide additional incentives for improved governance of banks. • <u>Build on recent legal and institutional reforms and promote a more secure framework for lending</u>. These efforts can include (i) promoting secured transactions backed by a pattern

of fair but consistent creditor bias during contract disputes involving debt default; (ii) encourage frequent and accurate updating, and easy access and use of property and lien registries to enhance the supply of debtor information when creditors conduct risk assessment; (iii) consider use of out-of-court arbitration (alternative dispute resolution) for relatively small value transactions, in conjunction with international institutions for large transactions, and/or when contract disputes emerge and conflicting parties voluntarily opt for this mechanism instead of in-court procedures. • Strengthen accounting and audit standards to improve the quality of financial information disclosed to the public, and consider increasing the frequency of reports for larger firms. While this is a proposal that is required for the entire financial sector, it is also highly relevant for the real sector. This should be achieved through training to achieve (i) IAS/ISA, particularly in the enterprise sector; and (ii) better understanding of the use of accounting and financial disclosure for management and financing, rather than just for traditional tax-related purposes and formalities. • Support development of a more comprehensive credit quality database to track arrears and problem credits. A limited system exists within NBRM for exposures to banks. However, given the high level of arrears outside the banking system and the need to enhance documentation of credit performance at all levels of the economy, an effort should be made to track such exposures to all formal creditors (e.g., power companies, Government accounts and funds, enterprises), not just banks. This should be combined with efforts to support a broader understanding of the positive and negative incentives of information disclosure, and the importance of credit performance in obtaining loans and equity financing from formal financial institutions.
Benefits: These initiatives should help to consolidate recent reforms, and push the system towards increasing soundness. Once competition intensifies, this should lead to an increase in the range of products offered, and increasing efforts by banks to capitalize on potential in currently underserved markets (e.g., investment in electronic systems triggering growing consumer banking applications).
Risks: The downside to such assistance is that it may be construed as a subsidy to private banks that should cover their own internal training needs, develop their own methods of tracking credit risk, etc.
Linkage to USAID IR 1.3.1: These recommendations constitute building blocks for increased willingness and capacity to make loans (IR 1.3.1.1), and to enhance investor confidence (IR 1.3.1.3).

Linkage to USAID IR 1.3.2: Banking reform measures would provide direct opportunities to establish standards and vehicles for better private sector proposals (IR 1.3.2.1). Increased professionalism and risk management capacity imparted by banks would serve as a catalyst for firms to operate on sound business management practices (IR 1.3.2.2). Information requirements and enhanced risk evaluation capacity would also serve as a catalyst for firms to register, properly account and disclose information, and thus pay an equitable share of taxes (IR 1.3.2.3) to avoid issues of liability.
Linkage to USAID IR 1.3.3: The proposed banking reform measures would also reinforce USAID efforts to strengthen the business environment for investment (IR 1.3.3 and IR 1.3.3.3). Training and professional development in a number of areas also would contribute to business skills development in the labor force (IR 1.3.3.5), such as accounting.

Recommendation # 3.

Continue Movement Towards Effective and Increasingly Consolidated Banking Supervision
Description: NBRM has made strong progress in recent years in helping to contain risk in the banking system. However, additional areas of concern are consolidated supervision, risk management capacity, and market risk. As RM moves towards universal banking, increasing NBRM supervisory capacity will be necessary to support a stable financial system. Key initiatives that should be included are: • Support efforts to achieve the preconditions for effective bank supervision according to BIS-recommended guidelines. This would include (i) full adoption of internationally accepted accounting and disclosure practices; (ii) free and undistorted capital markets; and (iii) fundamental institutional reforms in support of macroeconomic growth and political stability. • Strengthen licensing capacity of the NBRM, and consider amending recent banking legislation to tighten up on disclosure requirements of bank owners with less than 10 percent voting rights. NBRM is largely compliant with most of the principles covered under licensing and structure. However, areas that could be further addressed include (i) the confusion created by the poorly conceived levels of ownership (i.e., under 10 percent) that are allowed before supervisory approval is made; (ii) the need for better information on the source of funds of these investors; and (iii) further clarification on the status and function of savings houses to define their permissible activities under the recently revised Banking Law. • Strengthen the capacity of NBRM to achieve full compliance with BIS standards on prudential regulations and requirements. Assistance in this regard should focus on improving capacity to assess (i) country risk; (ii) market risk; (iii) bank operational risk; and (iv) money laundering. Based on conversations with Supervision staff, the greatest area of uncertainty, and the area that needs to be addressed to implement the new "S" component in the CAMELS rating system, is the concept of market risk. Given the embryonic nature of RM's capital market structure, there is little understanding as to potential risks other than exchange rate risk. Increased foreign investment, and the development of domestic capital market instruments will eventually change this environment. Assistance in this area should be short-term in nature and focused on formal training. • Strengthen methods of ongoing banking supervision by expanding NBRM focus on consolidated supervision. This is a particularly difficult area due to the prevalence of informal groups or alliances that are hard to monitor (due to the restrictions on gathering information from shareholders owning or controlling less than 10 percent of outstanding

voting shares). The NBRM has recently developed regulations that allow the formation of defined banking groups, but has yet to draft a policy outlining procedures pertaining to consolidated supervision. It is recommended that the NBRM draft such a policy and that it incorporate a supervisory framework that evaluates the risks that non-banking activities conducted by a bank or banking group may pose to the bank or banking group. If necessary, additional regulations should be drafted to ensure that BSD has the legal authority to review the overall activities of a bank, whether the activities are conducted directly (including those conducted overseas), or indirectly, through subsidiaries and affiliates of the bank. Supervision must also have the authority to impose prudential standards on a consolidated basis for the banking organization, and to limit the range of activities the consolidated banking groups may conduct.

- Subject information requirements to stricter standards of disclosure. There is still a need for the implementation of, and adherence to, International Accounting Standards. While the NBRM is doing what it can to ensure accurate and timely information, they are not equipped to, nor responsible for, audit at the transaction level. Bank auditors, both internal and external, should be insisting on this issue of accounting transparency. However, RM has not reached the level of shareholder involvement that would result in demands for greater transparency. This area should be supported with assistance from donor agencies.

- Promote more active involvement by the Managing Boards of banks and savings houses in the implementation of formal and informal corrective actions. As this is generally a new process in this market, these changes should evolve through the normal course of operation. The NBRM is spearheading initiatives to increase communication between regulators and banking officials. This increased awareness of supervisory responsibilities should help in this matter.

- Strengthen the capacity of NBRM to supervise cross-border banking activities and operations. This should include (i) strengthening regulations to ensure that BSD has the authority to supervise the overseas activities of locally incorporated banks (i.e., additional regulations needed on foreign branches and subsidiaries; directives outlining the role of bank management in maintaining proper oversight of the bank's foreign branches, joint ventures, and subsidiaries; procedures to incorporate review procedures to ensure that local management of any overseas offices has the necessary expertise to manage those operations in a safe and sound manner); and (ii) establishment of good working relationships with other banking supervisory agencies (i.e., to facilitate the sharing of information, not only on banking activity, but also on ownership structures and sources of capital).

Benefits: In general, movement in this direction would increase prospects for maintenance of a stable and sound framework for banking and general financial sector development. Such

assistance could also be done in a relatively short time frame, and would thus be cost-effective.
Risks: After helping with banking supervision, USAID may wish to focus on other areas of priority, leaving NBRM to identify other sources of needed expertise and experience.
Linkage to USAID IR 1.3.1: More effective supervision would increase prospects for stability, which in the long run should increase the willingness and capacity of banks to make loans (IR 1.3.1.1), and enhance investor confidence (IR 1.3.1.3).
Linkage to USAID IR 1.3.2: Discipline exerted by banks as a result of regulatory pressure may help to establish standards and vehicles for better private sector proposals (IR 1.3.2.1), and for firms to operate on sound business management practices (IR 1.3.2.2).
Linkage to USAID IR 1.3.3: More effective supervision, particularly on a consolidated basis (over time as banks become more complex) should reinforce USAID efforts to strengthen the business environment for investment (IR 1.3.3 and IR 1.3.3.3). More effective supervision should also lead to the refinement and adaptation of certain laws and implementing regulations (IR 1.3.3.1) over time.

Recommendation # 4.

Consider Modest Refinements to the Current Deposit Insurance Framework
Description: The DIF has succeeded in recent years with two incidents of payout without the spread of panic in the system. While depositor confidence in the banking system is far from fully restored, there are clear signs of progress. Nonetheless, some modifications to the current framework may help increase the participation of potentially large depositors in the banking system. These measures include: • Amend current practices to eliminate deposit exclusions. These exclusions are poorly conceived and anti-competitive. Firstly, to exclude deposits that are receiving an arbitrarily defined "privileged" rate of interest is not proper and cannot be supported. Presently, under a liquidation scenario, any deposit that exceeds the average rate on those types of deposits could be considered privileged and excluded. To track when those funds were received, under what rate environment etc., is an enormous undertaking and is counterproductive. While it is easily understood why the DIF would try to discourage "privileged" rates of interest, it is not a feasible exclusion in a deposit insurance system. In addition, this would not allow a sound, well-managed bank from doing short-term promotions to attract funds, as depositors would not risk losing insurance protection under this scenario. • Amend current practices excluding the deposits of significant shareholders (those with 10 percent or more of the voting stock) from deposit insurance coverage. This is also unfair and counterproductive for the system as a whole. Controlling shareholders in any country generally are individuals and entities with money. To exclude classes of individuals with funds is not sound policy. The same holds true for members of the managing board. Generally, board members are people of means and these are people the banking system needs to attract under sound policies and practices. To exclude managing board members and all their immediate relatives is ill conceived. • Increase coordination and information flows between NBRM and DIF. Currently, the DIF operates as a payment "box" and is not an actively involved participant. The Fund needs to increase the flow of information between the NBRM Supervision Department and itself. This is not to equivalent to supervisory authority. However, it would be beneficial for DIF to have a voice in the decision-making process, and not treated merely as an administrative funding source.
Benefits: Modifications noted above would be in keeping with EU norms.
Risks: The major risk is that potentially large depositors have sometimes abused banking systems in the past, and they have managed to manipulate deposit insurance schemes via insider information. Regarding USAID, this may not be a high priority given the range of challenges that exist in building a viable financial sector.

Linkage to USAID IR 1.3.1: A sound and trustworthy DIF should enhance depositor confidence, which should increase investor confidence (IR 1.3.1.3).
Linkage to USAID IR 1.3.2: The DIF does not directly relate to IR 1.3.2.
Linkage to USAID IR 1.3.3: The proposed recommendations on deposit insurance might help to strengthen the business environment for investment (IR 1.3.3 and IR 1.3.3.3) by increasing deposits, and thus making funds more available for lending and investment.

Recommendation # 5.

Support Long-Term Measures to Increase Prospects for a Viable, Active and Transparent Securities Market with Regional Links
Description: To date, the MSE has failed to mobilize significant capital resources. This is largely due to the unstable economic and political conditions that have adversely affected market development in RM. In addition to continued support for accounting reform (and needed conversion of firms to IAS to be able to list), there are some initiatives that could be sustained for market development. However, this view should be medium- and long-term in achieving stock market capitalization and turnover ratios that remotely resemble those of better performing neighboring markets, let alone major markets around the globe. For this reason, and recognizing the limited capital and opportunities likely to be available in RM, efforts to achieve growing regional integration would help. In this regard, warehouse receipts could be packaged and securitized on the MSE or on regional exchanges, while other products such as mortgage and municipal bonds, corporate bonds, etc. should be viewed as a medium- to long-term objective. Some measures that might move the MSE in this direction include the following: • Support legal, regulatory and other efforts to change incentives regarding investment and listing on the First Market of the Macedonian Stock Exchange. MSE currently has one actively traded listed company, and one bond that is traded. There is strong reluctance by companies to list, as this would disrupt ownership structures. Currently, the exchange (especially the Third Market) is being used by various parties to change controlling interests in various companies. Individual shareholders are discouraged by management from selling their shares, and most shareholders have been pressured to cede their voting rights to management. The SEC office in RM works primarily with disenfranchised stockholders who wish to sell their stock, but are being forced to agree to prearranged schemes by senior management of their firms. • Strengthen SEC capacity by working with IOSCO to enforce basic standards. There are many areas where the markets do not comply with standards, including principles of self-regulation, principles of cooperation, and principles for issuers. Addressing these and expanding observance of other principles would help to attract portfolio investment (including channeling remittances, etc) and provide liquidity for listings on the First Market. • MSE may need to strengthen its outreach to companies to increase listings, although ownership/share manipulation appears to constrain these prospects. Links to other markets may constitute the best method for reversing these constraints. • Build on progress to date in the agro-processing sector, and seek to develop sufficient inventory of warehouse receipts for subsequent syndication and, eventually, securitization. While securitization might be along-term objective, syndication to/through

banks should be a feasible option in the near to medium term once banks can assure underlying credit quality. Recent assistance in this direction should help to document collateral values of underlying security, making it easier for banks to consider such financing. This would essentially resemble a factoring option that would later culminate in securities issues. • Seek to establish the needed infrastructure and institutions that would culminate in mortgage lending, followed eventually by mortgage bonds or securitization. While bonds or securitization are likely five-10 years away, assistance can be provided in a number of municipal government activities (e.g., land use planning, property tax assessments, public-private provision of needed services) to make the environment more conducive. Recent improvements in property, pledge and share registries also will help over time on the condition they are quickly updated and accessible. • Seek to establish the conditions for municipal bond issuance to be feasible. This is likely 10 years away, but should focus on development of clear central-municipal tax powers, transfer arrangements, professional standards of budget management, and development of a viable fiscal base at the municipal level.
Benefits: Should such movement occur, it would be immensely beneficial to enterprises and banks. The former would benefit from additional amounts and types of financing. Banks would benefit from diversification in the marketplace, both as a provider of funds as well as a destination for allowable investments in securities.
Risks: In addition to political risk, there is a fundamental limit to how much can be achieved in relatively poor markets with a small number of firms. However, it is hard to see how the economy will move forward without a capital markets option.
Linkage to USAID IR 1.3.1: Continued assistance in this direction would directly support movement towards transparent equity market development (IR 1.3.1.2), and would consequently enhance investor confidence (IR 1.3.1.3). Such financing would also reduce pressure on banks to be the major source of formal finance, which would then provide additional capacity for banks to make loans (IR 1.3.1.1).
Linkage to USAID IR 1.3.2: More viable and transparent capital markets would require standards for better private sector proposals (IR 1.3.2.1) and sound business management practices at firms (IR 1.3.2.2). This would also serve as a catalyst for firms to register, properly account and disclose information, and thus pay an equitable share of taxes (IR 1.3.2.3) as a precondition for attracting financing.
Linkage to USAID IR 1.3.3: More effective capital and equity markets would strengthen the business environment for investment (IR 1.3.3 and IR 1.3.3.3), including with refinement of commercial laws and implementing regulations (IR 1.3.3.1).

Recommendation # 6.

Support Efforts to Develop a Viable Insurance Sector
Description: The insurance sector is underdeveloped in RM, yet serves as an important building block for business development and household/family protection. While there are only four insurance companies, the major one provides a wide range of products and has a sound reputation in the domestic marketplace. Others are likely to follow over time. This will require that adequate supervisory capacity is in place to enforce a sound legal framework, and to monitor for risks of abuse. The following constitute areas of assistance that USAID might contemplate to help advance the development of the insurance sector: • Technical assistance, financial assistance and training in the form of (i) support for the drafting of implementing regulations (if other sources of technical assistance are unavailable or insufficient); (ii) training and education in the business of insurance and its regulation, especially in the more technical areas (e.g., actuarial science, solvency regulation); (iii) training for additional requirements under the new law – such as the licensing of insurance brokers – for which the Insurance Supervisory Agency lacks resources; (iv) involvement with international insurance regulatory organizations, such as IAIS, to keep current with best practices in the field and to collaborate with regulators from other countries; and (v) financial support and the provision of short-term or long-term resident experts. • Strengthening the nascent regulatory system to encourage reliable and affordable insurance coverage. Business insurance, by enabling firms to control and quantify risk, helps to provide the foundation for a stable cost structure and profitable development. Business insurance, both property and liability, is important to permit firms to guard against catastrophic exposures (e.g., the destruction of buildings or manufacturing facilities by fire). With respect to less devastating risks, insurance provides a means of transforming losses that are uneven over time and difficult to predict into relatively certain streams of premium payments. As such, the development of a stable, reliable insurance industry to provide business insurance in which firms have confidence is an important objective for economic and market development. An effective regulatory system is a precondition for such insurance. • Encouraging insurance market development. Personal lines insurance—especially coverage of homes against fire and other perils, and motor vehicle coverage—is also important. In RM, the same companies that offer business insurance offer personal lines coverage. However, there is virtually no life insurance sold. Its development should not be a priority.
Benefits: Insurance sector development would provide an ample range of coverages that would

increase the willingness of businesses to make investments or transactions that might otherwise not occur. Enhanced supervisory capacity would promote stability, particularly important now that banks and others are permitted to enter the insurance sector to increase competition.
Risks: The major risk is the possibility that enterprises will simply balk at paying for insurance products, particularly if fraudulent claims and other potential risks ultimately lead to an impression among the public that insurance companies only collect premiums. To counter, insurance companies may charge high premiums to offset this risk. However, that might cause the prices of needed policies to be too high, particularly for relatively small companies.
Linkage to USAID IR 1.3.1: Insurance sector development would enhance investor confidence (IR 1.3.1.3). This, in turn, could potentially increase the willingness of banks and others to make loans (IR 1.3.1.1). Should insurance companies grow, they could also emerge as institutional investors. If so, this might help to stimulate transparent equity market development (IR 1.3.1.2).
Linkage to USAID IR 1.3.2: Insurance sector development would serve as a catalyst for firms to operate on sound business management practices (IR 1.3.2.2), with the possibility of receiving lower premiums on policies over time based on performance.
Linkage to USAID IR 1.3.3: The proposed recommendations for insurance sector development would reinforce USAID efforts to strengthen the business environment for investment (IR 1.3.3 and IR 1.3.3.3).

Recommendation # 7.

Support Movement Towards Implementation of the Second Pillar Pension Scheme
Description: Fiscal and demographic pressures have combined to render the PAYG system unsustainable in the long run. Successful implementation of the second pillar would help RM move forward with needed reform, while also serving as a catalyst for sound institutional investment over time. Recommended is the following: • <u>Provide financial and technical assistance to support implementation of the new Pillar Two system</u>. Support would be provided for the following: (i) policy development (drafting of regulations); (ii) preparation of accounting standards; (iii) institutional development of the Pension Supervisory Agency; (iv) organization of the public tender; and (v) development of the information system. The total amount of assistance needed was estimated by the Pension Supervisory Agency to approximate \$1.5 million. This recommendation is based on a series of considerations, including the complexity and amount of work needed to implement the new system, the tight time-frame established in the new law, the investment to date in this project, and the relatively compact amount of assistance needed relative to USAID resources available.
Benefits: Movement in this direction is sound for macroeconomic and institutional reasons. Such assistance could also be provided at comparatively low cost.
Risks: Risks include the potentially limited impact the second pillar may have over the course of the next several years and possibly decades. This reform requires a long-term focus, particularly as more than a third of the official labor force is routinely classified as unemployed. However, near-term results can be achieved by setting in place a sound regulatory structure and framework, and reinforcing public trust and confidence early on.
Linkage to USAID IR 1.3.1: Pension fund development could serve to stimulate transparent equity market development (IR 1.3.1.2) over time, as these funds would be investing most of their investible resources in domestic securities. The presence of well managed funds in the market could enhance investor confidence (IR 1.3.1.3), particularly if they adhere to prudent and sound investment principles that perform well over time.
Linkage to USAID IR 1.3.2: Pension reform might serve as a catalyst for firms to register, properly account and disclose information, and pay an equitable share of taxes (IR 1.3.2.3) to participate.
Linkage to USAID IR 1.3.3: Training and professional development might build capacity in the business sector, possibly contributing to business skills development in the labor force (IR 1.3.3.5), such as in accounting and modern business administration practices.

Recommendation # 8.

Consider Sustained Support for Non-Bank Intermediaries as a Basis for Providing Financial Services to Those Not Traditionally Served by Banks, and to Accelerate Niche Market Development
Description: Much of the non-bank sector is underdeveloped. For instance, there is now new leasing legislation that should theoretically open up the doors to market development, given adequate tax and depreciation allowance. However, there are other practical constraints to development of this sector. USAID has had good luck in supporting micro-finance initiatives in RM, and modification of existing savings house legislation could potentially make the environment more conducive to credit union development. At a minimum, it will be important for economic development purposes as well as political reasons to provide services so that households, rural communities and others do not feel disenfranchised from the formal financial system. Initiatives might include the following considerations: • <u>Credit union development represents a useful member-based approach to savings and lending</u>. Current legal restrictions, licensing limitations (e.g., domestic currency operations only when people generally save in hard currency), small pools of funds for lending (which counters the ability of credit unions to grow), and past problems with savings houses make it difficult for credit unions to rapidly develop. However, there is a real risk that banking consolidation over time will leave rural communities and small households with little formal sector alternative. Under proper scrutiny, credit unions can serve as an attractive, well managed alternative to banks for small-scale savings and lending. • <u>Micro-finance can provide relatively small loans for cottage industries, commercial trade, and services</u>. In some ways, micro-finance can be viewed as effective assistance in trying to reduce poverty, while also trying to establish market norms of discipline (rather than grant assistance through Government programs). Particularly if there is potential for businesses to graduate upward in size, micro-finance can be helpful in providing credit to small enterprises that are usually not serviced by banks. Continued efforts might look to encourage syndication upward to banks if packages of loans with strong performance can be mobilized. • <u>Savings houses continue to be small and a supervisory dilemma for NBRM</u>. Savings houses are reported to have only a small amount of deposits, although sufficient levels of household deposits (about 6-7 percent, although this may be less now due to the major influx of deposits to the banks in 4Q 2001) to be of concern. The main risk to savings houses is that they could potentially be misused. However, as their deposit base is small, the risk is not systemic, and any failures could be covered by DIF. NBRM will need to monitor these savings houses for safety and soundness. From a policy standpoint to rationalize the supervisory function, NBRM might consider higher minimum capital

requirements (or consolidation with banks) once all major towns in RM have at least three licensed bank branches. • Encourage development of the leasing sector. Leasing is often a helpful complement to bank lending, particularly in the industrial sector. NBRM will need to monitor bank exposures to private leasing companies to ensure that bank CARs are not overstated. Over time, NBRM might consider easing the 1:1 fixed asset to capital ratio requirement once banks demonstrate capacity to increase investment in fixed assets for leasing, and to manage more risk.
Benefits: As a rule, non-bank financing such as leasing helps to diversify financing options, providing opportunities to spread risk and encourage price competition. Micro-finance and credit unions often serve as a disciplined basis for small savings and credit, and as a tool in helping to reduce poverty.
Risks: NBRM appears to have little interest at the moment in energizing the savings house movement. This weakens prospects for credit unions.
Linkage to USAID IR 1.3.1: These recommendations increase capacity to make loans (IR 1.3.1.1).
Linkage to USAID IR 1.3.2: Micro-finance and credit union activity establish basic standards of market discipline, which serves as a catalyst for better private sector proposals (IR 1.3.2.1) and basic business management practices (IR 1.3.2.2) at the household/small business level. These kinds of institutions can also serve to encourage small firms to register, properly account and disclose information, and thus pay an equitable share of taxes (IR 1.3.2.3).
Linkage to USAID IR 1.3.3: Micro-finance and credit union activity often provide training that contributes to business skills development in the labor force (IR 1.3.3.5).

Recommendation # 9.

Establish a Licensed Specialized Financial Institution
Description: This specialized financial institution could be based on the American Enterprise Fund banks established elsewhere in transition countries, but with a focus on key non-bank financial markets. This could include one or several of the following options (as well as unnamed options): leasing, mortgage finance (and eventually bonds or securitization), commercial finance, factoring, a closed-end investment fund to be listed on the MSE, other investment fund(s), special purpose trusts for investment in bonds/securities, etc. In light of the existing RM system being "over-banked", it is not recommended that this institution be a deposit-taking institution insured under DIF. However, given USAID criticism of many banks for being excessively risk-averse, and the view that some project assistance has yielded inadequate results, a specialized financial institution might be more able to respond to perceived market opportunities.
Benefits: The benefit of this approach is that it can be customized to fit a particular market opportunity, and then grow as reforms take hold and other market opportunities appear. Should this approach be pursued in only one or two limited areas of focus, the actual level of capital required for start-up and initial operations might not be excessive. General benefits would be increased lending/investment, the introduction of new products and services, and establishment of separate subsidiaries that could take advantage of opportunities as they emerge in the coming years with structural reform (e.g., pension fund, insurance, mortgage finance, municipal bonds). Such a financial institution could be essential in raising standards of corporate governance, financial disclosure, and credit risk management. It could also accelerate movement by banks into consumer banking (due to increased competition in other areas), securities and contractual savings market development, mortgage finance, leasing, and related areas of opportunity. The presence of a specialized finance institution might also serve as a catalyst for investment in needed systems that have sometimes been deferred at the expense of efficiency. In the process, such developments might also serve as a spur to needed consolidation of the banking system with better capitalized banks.
Risks: There are three basic risks—capital, policy, and market risk. For start-up, the institution would need capital. This could be a large proportion of available funding, and would thus crowd out other needed areas of assistance. One alternative to mitigate costs might be to seek interest from one of the existing AEF banks (e.g., Bulgaria) on setting up a branch. This might represent a relatively low cost approach to introducing a specialized financial institution that would grow over time, and leverage off of retained earnings. Should there be a viable market, such an institution might also be willing to share in the required capital, thus providing USAID with leveraging capacity for its capital or grant commitment. The policy risk of this approach is that it could be criticized for introducing added competition to a banking sector that is eventually planning to engage in non-bank activities to diversify and increase its earnings stream. On the other hand, it represents an opportunity to send market signals through a commercial institution taking on risk. The non-deposit-taking status of the institution would offset criticism that it is taking away market share from private banks in a small market. Finally, there is the market itself. It may simply be premature for a specialized finance institution to enter the market for such

purposes. This is particularly the case if there are funding constraints, as implied by its non-deposit-taking status. The latter constraint would presumably impede the ability of such an institution to make a significant number of individual mortgage loans, or provide the long-term financing required for leasing. However, this risk may be partly mitigated by establishing a closed-end investment fund or some other investment fund that would obtain additional capital, and then list on the market. Such a fund could then attract investment funds into well managed companies, and set an example of sound investment fund governance practices to enhance management and performance at the companies in which the fund would be a shareholder.
Linkage to USAID IR 1.3.1: The proposed specialized financial institution would be willing and able to make loans (IR 1.3.1.1), although the focus would presumably be for lending in niche areas that have not been covered, and for which there appears to be a market. This might include equipment and lease financing, commercial finance on a long-term basis, and mortgage finance (e.g., commercial property development). However, its primary thrust would likely be from the investment side, with one of the options being a closed-end fund that would list on the MSE (IR 1.3.1.2), or some other kind of fund. This could potentially enhance investor confidence (IR 1.3.1.3), particularly if performance is strong and widely reported.
Linkage to USAID IR 1.3.2: The proposed specialized financial institution would be in a position to lend (e.g., mortgage loans, leasing) and invest (e.g., closed-end investment fund). This would directly relate to private sector efforts to offer lenders and investors better opportunities and proposals (IR 1.3.2.1). A precondition for such investment would be demonstrated sound business management practices (IR 1.3.2.2), although some mortgage lending to individuals would simply require demonstration of credit worthiness (which is a sound business management practice). Such requirements and standards, such as for a closed-end investment fund, would require formal registration of recipient firms. Thus, the presence of such an institution could help to serve as a catalyst for equitable tax payments by firms (IR 1.3.2.3) based on proper accounting and disclosure of information.
Linkage to USAID IR 1.3.3: The existence of a specialized financial institution would actually be in a position to invest directly reinforcing the end result of an improved environment for investment (IR 1.3.3, which is also IR 1.3.3.3). Such an institution would be taking risk, and therefore be in a position to make constructive recommendations on the legal and regulatory framework (IR 1.3.3.1 and IR 1.3.3.4), and policies conducive to private sector growth (IR 1.3.3.2 and IR 1.3.3.4). The market test for firms obtaining investment or loan proceeds would also serve as an incentive for firms to have the necessary business skills among their staff (IR 1.3.3.5).

Recommendation # 10.

Include Financial Sector Issues as Part of Larger Legal Reform Efforts
Description: RM has adopted many laws in recent months, and more are in process. Nevertheless, the laws have often been prepared with outside assistance, and there are concerns that these are being adopted without significant "buy-in". Even if there is broad consensus, there is the remaining issue of implementation. Specific to the financial sector, broad efforts could (i) support implementation of any additional needed provisions to assist with the fair enforcement of creditors' rights in contract disputes; (ii) reinforce the emerging framework for secured transactions; (iii) encourage open access to information related to financial transactions (e.g., automated database access on liens, pledges, mortgages); and (iv) address financial fraud, money laundering and other financial crimes in criminal courts (in addition to their treatment in commercial courts).
Benefits: The overall benefit would be a strengthened and more harmonized legal system that would provide a clearer legal framework as well as regulatory effectiveness.
Risks: No major risks are identified as this is simply a recommendation for coordination, harmonization and synchronization of efforts. The above recommendation is based strictly on discussions from meetings regarding some of the practical shortcomings of the existing system.
Linkage to USAID IR 1.3.1: A clear legal framework with consistent judicial enforcement would be expected to increase financial institutions' willingness and ability to make secured loans to firms, and therefore relevant to IR 1.3.1.2. Legal clarity and consistency would also be expected to encourage better governance, protect shareholder rights, and other fundamentals that would increase prospects for a viable, accessible and transparent equity market (IR 1.3.1.2), and increase investor confidence (IR1.3.1.3).
Linkage to USAID IR 1.3.2: A strengthened legal environment for financial services providers would assist with the financial discipline imparted to private sector firms. This would provide an additional incentive to firms to exercise sound business management practices (IR 1.3.2.2) as a basis for remaining on good terms with lenders and investors. Such legal clarity backed by enforcement would also provide an incentive to firms to present sound proposals to lenders and investors (IR1.3.2.1), and to comply with tax-paying obligations (IR1.3.2.3) to avoid liability that would undermine continued access to financing.
Linkage to USAID IR 1.3.3: The existence of coordination and harmonization of financial sector legal efforts (including consistent enforcement) would strengthen the business environment as a whole (IR 1.3.3 and IR 1.3.3.3) by removing contradictions or differences across different pieces of legislation.

Recommendation # 11.

Support Independent Financial Services Associations
Description: One or more independent financial sector trade associations with special committees focused on individual sub-sectoral issues (e.g., banking, securities, insurance, pension funds, leasing, credit unions, micro-finance, etc.) would be expected to enhance the role of financial services providers for both policy and market development. While associations tend to be biased as lobbying organizations, they are also capable of gathering essential market information that can be useful in the policy-making process. The association would provide a vehicle for (i) policy recommendations and review through interaction with Government authorities; (ii) training, certification, and codes of conduct; (iii) market information; and (iv) market making, including for the provision of needed services to assist lenders and investors with credit checks, back office operations, etc.
Benefits: There could be significant benefits for development of financial services as a whole. For instance, standards-setting by bankers and insurance firms on how to meet underwriting standards could be coordinated through relevant sub-committees in conjunction with regulatory authorities. The Macedonia Stock Exchange's communications and outreach efforts could be marketed in cooperation with the association, particularly if an enterprise data base were established to assist with market-making and prospecting for companies that are both credit worthy and potential equity targets. The association could consider joint efforts that would benefit the sector as a whole, such as joint ventures for harmonized software to improve clearinghouse operations for small value payments. More broadly, effective initiatives could potentially provide greater integrity in the policy making process, and reduce the reputation of patronage that still permeates some of the financial system.
Risks: There are several risks associated with business associations, including political and operational, as well as the potential opportunity cost if such assistance proves ineffective. The political risk is that they can be manipulated by governing authorities, or that their inherent biases and self-interest are subjective with regard to larger policy-making issues. Moreover, the very nature of competitive forces suggests that competitors will not seek to share information for broad market purposes, but rather will seek to protect information and perceived advantages in the marketplace. This undermines the operational capacity of the associations. However, this risk can be partly offset by broad consensus on key sector objectives that are beneficial to the system as a whole, such as broad market indicators of performance or trends, spending habits, etc. An additional operational risk is membership. Absent the presence of key institutions, the association would be less effective. However, should the major institutions be members, their influence may alienate the smaller members and undermine the potential effectiveness and benefits of a properly functioning association. Overall, should support for an association prove ineffective, this would also prove to be an opportunity cost at the expense of needed assistance in other key areas.
Linkage to USAID IR 1.3.1: The association could serve as a vehicle for key training and seminars for financial services companies not covered by their own internal training programs. This would respond to some of the training requests articulated by institutions in RM. Development of local institutes for banking, insurance, etc. could also serve as a potential vehicle

for training and certification, and as a basis for disseminating codes of conduct/ethics consistent with professional standards. Gathering and disseminating relevant market information would help financial firms with trends. Serving as a platform for technical service providers (e.g., IT, business advisory services) that advertise to financial services firms could initiate a potentially useful outsourcing market that would also help to create jobs. All of these initiatives if well implemented would serve to enhance the willingness and capacity of financial institutions to make loans (IR 1.3.1.1). If accompanied by outreach programs with other groups (e.g., MSE), this could also contribute to equity investment (IR 1.3.1.2). Helping to improve the accessibility, quality, veracity and timeliness of information could also contribute to the enhancement of investor confidence (IR 1.3.1.3).
Linkage to USAID IR 1.3.2: An independent and well functioning financial services association could help to support a more competitive private sector in several ways. One of the keys would be serving as a clearinghouse of information on underwriting standards, including formats, legal agreements, collateral requirements, etc. This might help existing advisory services and others with efforts to present lenders and investors with better opportunities (IR 1.3.2.1), although this is not guaranteed due to businesses often presenting business plans and loan requests prepared by others (e.g., outside advisors) and failing to convince lenders/investors that it is their plan. However, if the association were to serve as a clearinghouse, this would also be a vehicle for communicating some of the business management standards lenders and investors expect as one of the conditions for underwriting loans, investments, and insurance policies. This would relate to efforts to familiarize private sector firms with sound business management practices (IR 1.3.2.1). There would be no particular link to efforts to increase the percentage of firms that pay an equitable share of taxes (IR 1.3.2.3), although one of the preconditions for obtaining loans, investment or insurance coverage might well be proof that recipients do not have outstanding arrears to fiscal authorities.
Linkage to USAID IR 1.3.3: The existence of a financial services association would provide input into the legal and regulatory drafting process (IR 1.3.3.1), provide an industry (or sub-sector) voice for policies conducive to private sector growth (IR 1.3.3.2) and increased investment (IR 1.3.3.3), and clearly be structured to advocate legal and policy positions (IR 1.3.3.4). It is uncertain if the proposed association would play any particular role in increasing business skills of the labor force (IR 1.3.3.5), although there could be some spillover via training, seminars, outreach, etc.

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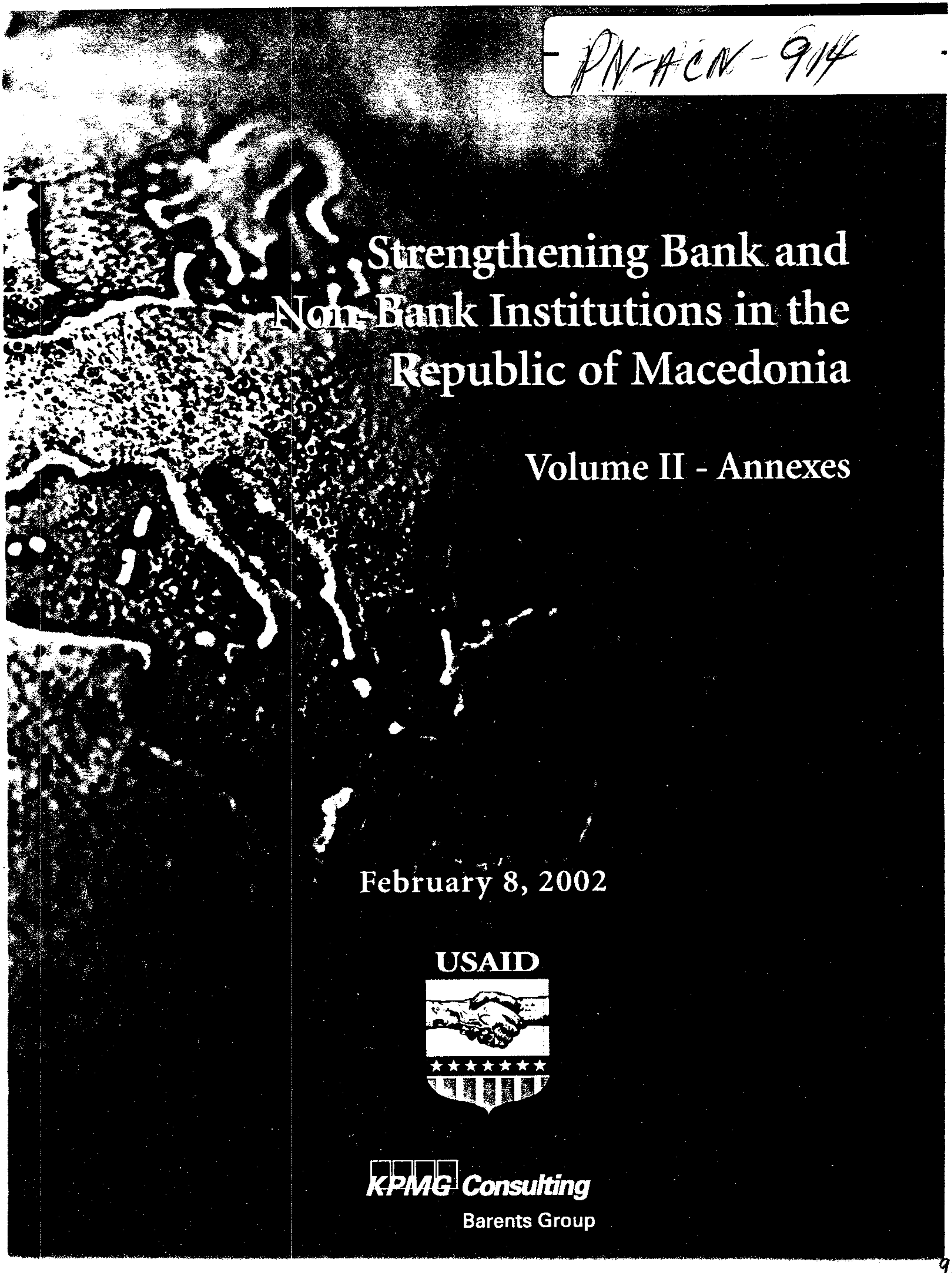

Strengthening Bank and Non-Bank Institutions in the Republic of Macedonia

Volume II - Annexes

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USAID

KPMG Consulting

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ANNEX 1: BANKING AND FINANCIAL INTERMEDIATION

Michael Borish is responsible for the contents of Annex 1, produced as part of a financial sector assessment conducted by KPMG-Barents Group. The assessment was performed to feed into USAID's ongoing efforts to strengthen bank and non-bank financial institutions in the Republic of Macedonia. Information for this assessment was obtained during an on-site visit from January 16, 2002 through January 29, 2002.

I. THE FUNDING SIDE: DEPOSITS, BORROWINGS, AND CAPITAL

A. Funds Mobilization

Intermediation patterns show that confidence has begun to strengthen in recent years. This is attributed to a series of factors, including (in no particular order) lower inflation rates, introduction of a new deposit insurance fund, the privatization of Stopanska, the presence of other foreign banks that have increased capital in their acquired banks, corrective actions taken in several other banks, the tightening of prudential norms and strengthening of supervisory capacity, and the redemption of interest on bonds issued to holders of frozen foreign currency accounts. While deposit figures provided by the IMF (in IFS) and NBRM are not identical, they both show that deposit mobilization trends are positive. IMF figures show that (i) current account deposits grew fairly steadily in 1998-99, leveled off in 2000, and then declined in 2001; (ii) time deposits grew at similar levels in 1998-99, and declined in 2000-2001 as enterprises withdrew deposits and depositors more generally shifted funds into foreign currency accounts; and (iii) foreign currency accounts increased substantially in 1998 and 2000, while being flat in 1999. The influx of deposits in 2001 is extraordinary, and explained by the conversion to the Euro.

Table 1: Year-to-Year Deposit Growth: Flow Basis

	Incremental Deposits ($, mn)				Yr-to-Yr Change			
	1998	1999	2000	2001	1998	1999	2000	2001
Domestic Currency	50	64	-2	-47	24.7%	25.4%	-0.8%	-15.0%
O/w Current Accounts	28	32	6	-33	24.9%	22.5%	3.5%	-18.3%
O/w Time Deposits	22	33	-8	-14	24.5%	29.1%	-5.8%	-10.6%
Foreign Currency	32	1	64	439	26.7%	0.9%	42.3%	203.9%
Total	82	66	61	391	25.5%	16.3%	13.1%	73.7%

Notes: 2001 figures are not final and are based on NBRM estimates and approximations

Source: IMF; NBRM; authors' calculations

Meanwhile, NBRM figures indicate that households have been the clear driving force behind aggregate deposit growth, while the enterprise sector has registered only marginal gains since 1998 and a severe net decline in 2001. In the case of the enterprise sector, this was true in reference to sight and short-term deposits as well as long-term deposits. While it is encouraging that the household and other sectors have increased their deposits in recent years, the banking sector will not be as dynamic if the enterprise sector continues to experience tight financial constraints.

Table 2: Bank Deposit Trends by Non-Bank Client: Flow Figures

	Incremental Deposits ($, mn)				Yr-to-Yr Change			
	1998	1999	2000	2001	1998	1999	2000	2001
Sight/Short-term Deposits	77	57	70	298	30.1%	17.0%	18.0%	64.5%
O/w Local Currency	47	38	45	-39	27.4%	17.6%	17.6%	-13.1%
O/w Foreign Currency	31	19	26	337	35.3%	15.9%	18.6%	207.2%
by Economic Classification								
O/w Enterprises	42	51	23	-66	25.9%	25.2%	9.2%	-23.6%
O/w Households	33	5	45	365	40.3%	4.1%	37.8%	222.2%
O/w Other	2	1	2	-1	14.4%	6.2%	10.9%	-5.5%
Long-term Deposits	5	5	-7	3	10.9%	8.9%	-13.0%	6.1%
O/w Local Currency	2	3	-12	-6	5.2%	6.1%	-24.7%	-16.1%
O/w Foreign Currency	3	2	4	9	69.6%	27.0%	49.8%	65.8%
by Economic Classification								
O/w Enterprises	0	7	-7	-4	-0.4%	107.5%	-57.1%	-76.0%
O/w Households	5	-2	0	7	12.7%	-4.3%	-0.1%	16.3%
O/w Other	0	0	0	0	-46.5%	71.8%	-100.0%	0.0%
Total Deposits	83	61	63	301	27.2%	15.9%	14.1%	59.0%
O/w Local Currency	49	41	33	-45	23.0%	15.6%	11.0%	-13.4%
O/w Foreign Currency	34	21	30	346	36.8%	16.5%	20.5%	196.6%
by Economic Classification								
O/w Enterprises	42	58	16	-70	25.0%	27.6%	6.0%	-24.6%
O/w Households	38	3	45	372	31.2%	1.7%	27.7%	179.2%
O/w Other	2	1	2	-1	14.3%	6.3%	10.7%	-5.5%

Notes: figures derived from NBRM, and differ from IFS

Sources: NBRM, authors' calculations

On a "stock" basis, total deposit levels at end 2000 were 35 billion denars, or $531 million. IMF figures indicate that about two thirds of deposits are held in foreign currency and time/savings deposits. Unofficial estimates of deposits suggest that an even higher ratio was held in foreign currency at end 2001, likely on the order of 70 percent or more. Efforts to piece together local versus foreign currency holdings indicate that local currency demand deposits have held fairly steady at about one third of total deposits, but that there has been a consistent exit from local currency time and savings accounts in favor of increased foreign currency holdings. The trend should have continued with the Euro conversion at end 2001. The following table provides a profile of deposit figures and trends based on year-end measures.

Table 3: Bank Deposits in US$ Values (Year-end Exchange Rates)

	Total Deposits				Percentage Share of Total			
(millions, US$)	**1998**	**1999**	**2000**	**2001**	**1998**	**1999**	**2000**	**2001**
Domestic Currency	254	318	316	268	62.9%	67.8%	59.5%	29.1%
O/w Current Accounts	142	173	179	146	35.1%	36.9%	33.8%	15.9%
O/w Time Deposits	112	145	136	122	27.8%	30.8%	25.7%	13.2%
Foreign Currency	150	151	215	654	37.1%	32.2%	40.5%	70.9%
Total	403	469	531	922	100.0%	100.0%	100.0%	100.0%

Note: 2001 figures derived from November 31 NBRM figures plus estimates of incremental deposits in December 2001 related to the Euro conversion

Source: IMF; NBRM; authors' calculations

These trends largely reflect the gradual withdrawal of enterprise deposits across the board, while households' foreign currency accounts have risen as a proportion. At least as far as household deposit levels are concerned, they appear to reflect increased confidence in the economy, and in the safekeeping capacity of the banks. However, the move to foreign currency may raise doubts about the underlying stability of the denar and its fixed exchange rate with the DM (now Euro). The following table based on data from the NBRM provides a profile of deposit figures by economic classification, and trends based on year-end measures.

Table 4: Bank Deposits by Non-Bank Client

	Total Deposits				Share of Total Deposits			
($ millions, %)	**1998**	**1999**	**2000**	**2001**	**1998**	**1999**	**2000**	**2001**
Sight/Short-term Deposits	335	392	462	760	86.7%	87.5%	90.4%	93.6%
o/w Local Currency	216	254	299	260	56.0%	56.8%	58.6%	32.0%
o/w Foreign Currency	118	137	163	500	30.7%	30.7%	31.9%	61.6%
By Economic Classification								
o/w Enterprises	203	255	278	212	52.6%	56.9%	54.4%	26.1%
o/w Households	115	119	164	529	29.7%	26.6%	32.2%	65.2%
o/w Other	17	18	20	19	4.3%	4.0%	3.9%	2.3%
Long-term Deposits	51	56	49	52	13.3%	12.5%	9.6%	6.4%
o/w Local Currency	45	47	36	30	11.5%	10.6%	7.0%	3.7%
o/w Foreign Currency	7	9	13	22	1.8%	2.0%	2.6%	2.7%
by Economic Classification								
o/w Enterprises	6	13	5	1	1.6%	2.8%	1.1%	0.2%
o/w Households	45	43	43	50	11.7%	9.7%	8.5%	6.2%
o/w Other	0	0	0	0	0.0%	0.0%	0.0%	0.0%
Total Deposits	**386**	**448**	**511**	**812**	100.0%	100.0%	100.0%	100.0%
o/w Local Currency	261	301	335	290	67.5%	67.4%	65.5%	35.7%
o/w Foreign Currency	125	146	176	522	32.5%	32.6%	34.5%	64.3%
by Economic Classification								
o/w Enterprises	209	267	283	213	54.2%	59.7%	55.5%	26.3%
o/w Households	160	163	208	580	41.4%	36.3%	40.7%	71.4%
o/w Other	17	18	20	19	4.3%	4.0%	3.9%	2.3%

Notes: Giro accounts assumed to be in denars; figures exclude restricted deposits; 2001 foreign currency increase assumed short-term

Sources: NBRM; authors' calculations

Notwithstanding progress and the benefits of increasing creditors' rights, improving capacity for secured transactions, privatization of the banking sector, deposit insurance reform, corrective measures taken, regulatory reform and tightening, supervisory strengthening, and other important achievements in the last few years, problems associated with the enterprise sector point to one of the key challenges facing the RM financial sector: how to mobilize resources from the emerging private sector through more formal channels to bring down intermediation costs and increase efficiency in the delivery of financial services. The enterprise sector had about 55 percent of total deposits at end 2000 ($283 million), down from 60 percent ($267 million) at end 1999. (The ratios changed significantly in 2001, as enterprises withdrew deposits, and as households significantly increased them. Based on very preliminary estimates, enterprises accounted for only 26 percent of deposits, or $213 million.) Assuming the 25,933 enterprises registered for domestic VAT receipts with the Public Revenue Office, average deposits per enterprise approximated $8,213-equivalent at end 2001[1]. The low and declining deposits of enterprises constitutes an issue that is larger than the banking sector, and requires improvement of the business environment, as well as continued development of non-bank financial institutions and markets. However, until these issues are addressed, resource mobilization through any formal financial institutions will be constrained by a weakened enterprise sector.

Meanwhile, again, notwithstanding progress made in recent years, per capita deposits were low at $262, particularly when measured on a purchasing power parity basis[2]. While the level of deposits clearly increased in 2001 and should stay at about $400 per capita, this is still not very high by global standards. Given that other savings instruments (i.e., private pension funds, life insurance products) have not yet seriously developed in RM, this reflects a low stock of savings held in the banking system with little alternative aside from offshore placements or informal holdings.

B. Other Liabilities and Capital

Despite relatively low levels of deposits, overall funding for the banks is generally limited to deposits and capital. Capital increased in 1999-2000 as a result of NBRM efforts to increase capital at all banks via increases in minimum capital, and through privatization of state banks to strategic foreign investors. Preliminary estimates show that net capital may have declined slightly, although this will need to be confirmed as NBRM reviews year-end figures. The new Law on Banks adopted in 2000 raised minimum capital in stages to DM 21 million, and then to Euro 9 million[3]. This is slightly higher than the EU minimum for banks (of Euro 5 million). However, capital was still relatively low at 27 billion denars at end 2000, or about $404 million[4]. This works out to $18 million on average per bank. (Preliminary estimates for 2001 suggest that these figures may have declined a bit, not unexpected after a difficult year. Provisional figures show nearly 26 billion denars in net capital, or $375 million. This would be $17 million per bank.) In any case, such capital levels are fairly low. Considering that the largest two banks account for 20-33 percent of total capital (depending on which NBRM figures are used), this

1 $213 million/25,933 registered enterprises = $8,213.

2 Using the IMF figures that separate Government deposits from enterprise and household figures, per capita deposits with the banks were equivalent to $262 at end 2000. As a percentage of PPP incomes of $5,027, this was only about 5.2 percent of average incomes. Based on more traditional per capita income measures, year-end deposits were 16.1 percent of average incomes.

3 Ironically, the Euro 9 minimum capital requirement is less than the earlier level of DM 21 million.

4 These figures are net capital based on IMF figures published in International Financial Statistics.

means the remaining 20 banks only have about $9.7 million on average. This is barely above the Euro 9 million in minimum capital, and provides limited resources for anything but modest banking activities.

NBRM has focused on implementing a policy in which risk-weighted capital adequacy is required to be a minimum 12 percent of assets to avoid special supervisory measures and corrective actions. According to NBRM, system-wide CARs were nearly 37 percent at end 2000, compared with 28 percent in 1999. Closer scrutiny concerning the loan books of the banks persuaded bank supervisors that banks had under-provisioned for non-performing loans, overdue loans, and potential losses on interest. In addition, off-balance sheet items were equivalent to 17 percent of balance sheet assets, representing additional prospects for needed provisioning. Stricter requirements for CARs is also one of the reasons why banks have invested their increasing deposits in safe securities, as it is far easier to comply with solvency and liquidity requirements under the new prudential rules. The high level of assets placed abroad also reflects the assets of the four foreign banks that have entered the banking system since 1999 and recapitalized the banks, particularly Stopanska (NBG).

While capital adequacy requirements have been stiffened and minimum capital has been raised to reasonable levels as compared with Europe, the reality is that most banks in RM are small and limited in capital. Segmenting the market between the largest banks and the remaining banks[5], the latter group averaged only $6.9 million in capital at end 2000. This was below the minimum Euro 9 million requirement that is currently in place. In any event, at such levels, it is difficult for smaller banks to compete because of the limited quantum of earning assets, and the consequent impediments to increasing investment in systems needed for fee income-related services. There is also a risk that some of the smaller banks have been established to engage in money laundering and other activities.

There is a risk that small and poorly capitalized banks could obtain a license. However, NBRM has come to recognize the risk of issuing such licenses. There is recognition that there may be too many banks in RM, that this can complicate the supervisory function, and that small banks can present potential systemic risks depending on the nature of their behavior. However, part of the new approach to banking stability has included efforts to tighten licensing standards, and to follow BIS recommendations and "best practices" found in other countries. NBRM has provided time for previously undercapitalized banks to implement corrective actions to comply with minimum capital and other requirements. However, NBRM also has a mandate to appoint receivers should a bank require liquidation. Such conditions are specified if a bank's capital adequacy declines below 2 percent. Since 1999, two banks have been liquidated.

Because of the small size of the market, banks in RM generally have limited access to international financial markets, although foreign liabilities accounted for 18 percent of total balance sheet funding in 2000 and an estimated 9 percent at end 2001[6]. These figures are lower absolutely than in 1999 and relatively than in 1998 (23 percent). In fact, end 2001 estimates show the lowest level of borrowing from abroad since 1996. However, increased exposure to international syndicated loan markets and other foreign sources of financing may occur over time with the presence of foreign banks, and as the economy grows. However, to date, multilateral and

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[5] This figure uses NBRM figures (as compared to the higher net capital figures derived from statements presented by the IMF Net capital = Capital accounts of 33,120 million denars less other items net of 6,335 million denars (see *International Financial Statistics*). By contrast, NBRM showed the banks with capital of 19,102 million denars at end 2000, or 7,683 million denars less in capital.

[6] This was due to both asset growth and a decline in foreign debt.

regional development banks represent the major sources of debt carried by the banking sector. These banks have funneled funds either through private banks, or through the Macedonian Development Bank.

The lower level of foreign liabilities was offset by the $101 million increase in central Government deposits held with the banks. Other sources are immaterial, which shows that banks' funding generally derives from four sources: (i) deposits (55.7 percent at end 2001); (ii) capital (22.6 percent); (iii) Government deposits (10.9 percent); and (iv) foreign liabilities, mainly donor sources (9.0 percent). Given the unusual circumstances of December 2001, it would be expected by 2002 that the deposit share of total funding would diminish, and that other items would increase. The following tables present dollar-equivalent liabilities and net capital figures for the banking system in RM, and then relative shares of the various items relative to total balance sheet liabilities and equity.

Table 5: Commercial Bank Liabilities and Equity

(millions of US$)	1995	1996	1997	1998	1999	2000	2001
Total Deposits	368	326	322	403	469	531	922
Demand Deposits	147	117	113	142	173	179	146
Time, Savings, FC Deposits	222	209	208	262	296	351	775
Other Borrowings							
Money Market	0	0	0	0	0	0	0
Foreign Liabilities	85	138	186	250	262	233	149
o/w Syndicated Abroad	0	0	0	0	0	0	0
Central Government Deposits	39	32	30	42	48	79	180
Restricted Deposits	27	27	18	21	20	21	23
NBRM	106	106	43	44	21	12	6
NBFIs	0	0	0	0	0	0	0
Gross Capital	460	575	418	456	481	499	427
Other Items, Net	411	339	261	-137	-85	-96	-53
Net Capital	872	913	678	320	396	404	375
Total Liabilities and Equity	**1,497**	**1,543**	**1,277**	**1,081**	**1,216**	**1,279**	**1,654**
Number of Banks	6	22	22	24	23	22	22
Average L+E per Bank	249	70	58	45	53	58	75
Average Net Capital per Bank	145	42	31	13	17	18	17

Notes: "Money market" deviates from use of the term by NBRM, which claims banks' inter-bank market is essentially a money market. Using this definition, the figures would be different.
Source: IMF; NBRM; EBRD; authors' calculations

Table 6: Relative Share of Commercial Bank Funding

	1995	1996	1997	1998	1999	2000	2001
Total Deposits	24.6%	21.1%	25.2%	37.3%	38.6%	41.5%	55.7%
Demand Deposits	9.8%	7.6%	8.9%	13.1%	14.2%	14.0%	8.9%
Time, Savings, FC Deposits	14.8%	13.5%	16.3%	24.2%	24.3%	27.5%	46.9%
Other Borrowings							
Money Market	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Foreign Liabilities	5.7%	9.0%	14.5%	23.1%	21.6%	18.2%	9.0%
Central Government Deposits	2.6%	2.1%	2.4%	3.9%	4.0%	6.1%	10.9%
Restricted Deposits	1.8%	1.7%	1.4%	2.0%	1.6%	1.6%	1.4%
NBRM	7.1%	6.9%	3.4%	4.1%	1.8%	0.9%	0.4%
NBFIs	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Net Capital	58.2%	59.2%	53.1%	29.6%	32.6%	31.6%	22.6%

Notes: "Money market" deviates from use of the term by NBRM, which claims banks' inter-bank market is essentially a money market. Using this definition, the figures would be different.
Source: IMF; NBRM; EBRD; authors' calculations

II. LENDING: CREDIT AND ASSET QUALITY

A. Stocks and Flows

Bank credit in RM on a "stock" basis is low by international standards, but reasonable for transition countries. However, the "flow" of new credit, particularly to new private enterprises, has long been criticized as inadequate. In general, the flow of new credit has been constrained since 1999 when the insolvency or near insolvency of the banking system was recognized. At the time, the top 40 socially-owned enterprises had run up losses equivalent to about 3 percent of GDP in 1999 alone, and more on a cumulative basis[7]. Most of this was owed to socially/state-owned banks. In particular, Stopanska Bank was exposed with unsustainable levels of non-performing loans[8].

As has occurred throughout most banking systems that have been contaminated with high levels of non-performing loans, such bad credit management has eventually driven up the costs of intermediation while also having the adverse effect of reducing access to credit by sound, competitive enterprises. This has happened in RM, where the SME sector has often had difficulty accessing credit, either due to (i) a period in which preferred socially-owned enterprises benefited from directed credit, or (ii) a subsequent period in which the banking sector experiences a necessary period of stabilization for future lending, yet requires constraints on new lending by banking institutions due to the corrective actions being taken to recapitalize the balance sheet and comply with new prudential regulations for underlying stability. The net result for the SME private sector has been either limited access to credit from banks, relatively high costs (as banks seek to generate "abnormal" earnings to cover the cost of provisions of other non-performing loans, effectively a combination of perverse cross-subsidization and rent-seeking), or both. In any case, this represents a bleak scenario until the banking system is operating according to sound fundamentals.

Credit from the banking sector has actually been relatively high when compared to other transition economies, particularly CIS countries. Depending on the source of information, RM banks' net credit figures were about 19-23 percent of 2000 GDP, although very likely lower in 2001. This is not inconsistent with the performance of other non-CIS countries that have been disciplined in their banking sector reform efforts after major banking (Latvia in 1995) and/or structural (Bulgaria in 1996) collapse. Considering that RM figures are better than those of Romania, Albania and Lithuania in the Central European-Baltic region[9], and comparable to figures registered in Latvia and Bulgaria, RM's performance has not been as negative as routinely assumed.

Given the figures available from the IMF (IFS), the stock of non-government credit at end 2000 was equivalent to about $714 million, $106 million less than at end 1999. Thus, on a flow basis,

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7 See World Bank, Report No. P 7395 MK, November 17, 2000.

8 By 1999 when the bank was privatized, the Government had to assume DM 235 million in bad loans for the transaction to proceed. This was equivalent to about 35 percent of the banking system's net capital, and likely equivalent to all of Stopanska's capital at the time.

9 Figures are not available from the same source (EBRD) for Bosnia-Herzegovina or Yugoslavia. While some lending activity has resumed in the former, it is likely well below RM's ratios. Yugoslavia is in the process of revamping its system to regain its earlier prominent position in the region. However, there was very little new lending activity as of end 2001.

lending was negative in 2000. Other figures from NBRM show that credit to the real sector was only down about $3 million in 2000. On a stock basis, the IMF figures suggest that credit was above 20 percent of GDP. Again, this is low by international standards, but not low by transition economy standards.

On a *flow basis*, these figures are significantly lower (on a dollar basis) than the credit figures registered prior to 1998, when credit was routinely in excess of $1 billion. Generally, credit has shrunk since 1997. However, there are issues of loan quality and associated asset values (which vary across countries). Large credit exposures or ratios are not positive unless they are earning assets. In the case of RM, credit reached $2.8 billion in 1994, or 79 percent of GDP. Most of these turned out to be loans that were problematic for the banking system shortly thereafter (and probably were already). Absent sufficient macroeconomic growth to obfuscate the inefficiencies of the real sector (including the socially-owned enterprises that were the major debtors to the banks), most of these loans ultimately culminated in unsustainable losses that triggered the reforms introduced in 1995, and subsequently in 1999.

As a result of the more recent reforms, the RM banking system has undergone a period of corrective action and stabilization that is intended to meet global standards. Absent such efforts, it is unlikely that public confidence in the banking system would be restored, or that capital would at least reach minimum European standards. It is expected that in the coming years, some of the banks will make the changes needed in their systems and operations to meet modern standards. On the other hand, as progress has on the funding side (e.g., increased deposit mobilization, increased bank capital), new lending has not yet occurred in equal magnitudes. The following table highlights lending flows in RM in recent years.

Table 7: Commercial (Deposit Money) Bank Financing of Government and Enterprises: Flow Figures

(millions of US$)	1995	1996	1997	1998	1999	2000	2001
Total GDP	857	-203	-923	344	-445	37	-108
Claims on Government	-1,058	5	-120	-7	-4	90	0
Claims on State Enterprises	166	-52	-45	130	-102	-20	-25
Claims on the Private Sector	-604	99	-216	-249	57	-87	-182
Total Bank Credit	-1,496	52	-381	-126	-49	-17	-206
Gov't % of Bank Credit	70.7%	8.8%	31.5%	5.9%	7.5%	-522.3%	0.1%
SOE % of Bank Credit	-11.1%	-100.6%	11.8%	-103.2%	208.9%	114.6%	11.9%
Private Sector % of Bank Credit	40.4%	191.8%	56.7%	197.3%	-116.3%	507.7%	88.0%
Net Bank Credit/Incremental GDP	-174.5%	-25.5%	41.2%	-36.7%	10.9%	-45.9%	191.2%

Sources: IMF; NBRM; authors' calculations

Based on predominantly IMF figures, total net increases in bank credit have been negative every year since 1997. On a cumulative basis, net lending has declined $2.2 billion since 1995, as compared with the cumulative $441 million decline in GDP. In general, banks have shown limited willingness to provide new loan financing, largely due to the new prudential framework to meet risk-weighted capital adequacy requirements, liquidity requirements and foreign exchange cover requirements, and to contain losses that would result from additional exposure to many of the banks' traditional clients. In fact, based on the broader figures presented, most of the incremental resources banks held are being placed in safe securities (e.g., claims on Government, accounts with foreign banks) for prudential as well as pragmatic management reasons. Using

NBRM figures, trends show a less negative scenario, although lending has declined each year since 1999.

Table 8: Commercial Bank Credit to Non-Financial Entities: Flow Figures								
	Incremental Lending ($, mn)				**Yr-to-Yr Change**			
	1998	***1999***	***2000***	***2001***	***1998***	***1999***	***2000***	***2001***
Total GDP	344	-445	37	-108	10.3%	-12.1%	1.2%	-3.3%
Claims on Enterprises	180	-132	-18	-21	58.1%	-26.8%	-4.9%	-6.1%
o/w Local Currency	160	-114	12	-16	77.9%	-31.1%	4.6%	-5.9%
o/w Foreign Currency	20	-18	-29	-5	19.3%	-14.3%	-27.1%	-6.7%
Claims on Households	7	-1	13	-1	19.7%	-2.9%	33.8%	-1.0%
o/w Local Currency	7	-1	13	-1	19.7%	-2.9%	33.8%	-1.0%
o/w Foreign Currency	0	0	0	0	0.0%	0.0%	0.0%	0.0%
Claims on Other Clients	1	-1	1	-1	62.8%	-19.7%	37.0%	-15.9%
o/w Local Currency	-1	1	-1	2	-59.5%	94.3%	-53.1%	241.4%
o/w Foreign Currency	2	-1	2	-2	0.0%	-57.4%	172.9%	-82.6%
Totals	**188**	**-133**	**-4**	**-22**	54.4%	-25.0%	-0.9%	-5.5%
o/w Local Currency	**165**	**-114**	**24**	**-14**	68.7%	-28.1%	8.1%	-4.6%
o/w Foreign Currency	**23**	**-19**	**-27**	**-8**	21.7%	-15.1%	-25.2%	-9.4%
by Economic Classification								
o/w Enterprises	2.1%	-2.2%	-3.6%	-0.5%	2.4%	-2.4%	-4.0%	-0.6%
o/w Households	-2.2%	2.2%	3.4%	0.6%	-22.5%	29.5%	35.0%	4.8%
o/w Other	0.0%	0.0%	0.3%	-0.1%	5.4%	7.1%	38.3%	-11.0%
Totals	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
o/w Local Currency	**6.4%**	**-3.2%**	**6.6%**	**0.8%**	**9.3%**	**-4.2%**	**9.1%**	**1.0%**
o/w Foreign Currency	**-6.4%**	**3.2%**	**-6.6%**	**-0.8%**	**-21.2%**	**13.2%**	**-24.5%**	**-4.0%**
Bank Credit/GDP	4.1%	-2.1%	-0.3%	-0.3%	40.0%	-14.7%	-2.0%	-2.3%
Bank Credit/Assets	22.3%	-16.5%	-1.9%	-8.4%	82.5%	-33.4%	-5.7%	-27.0%
Notes: Derived from NBRM figures; 2001 credit figures for September 2001; excludes nonperforming, overdue, provisions; figures are different from IFS figures for private sector								
Source: NBRM; authors' calculations								

In terms of overall credit, banks had about $825 million in credit at end 2000, and possibly as little as $618 million by end 2001. Of these credit measures, most was outstanding to the "private sector". However, many of these "private" sector firms are former socially-owned or state-owned enterprises that were privatized through management-employee buyout schemes. In effect, many if not most have continued to operate as they did before "privatization". Thus, they have still not effectively restructured to be competitive, and banks' earlier exposures to these companies are precisely the reason why their loan portfolios were of such low quality. Bad loans still account for about 27 percent of total loans, notwithstanding the improvements banks are showing in terms of capital adequacy.

In the end, banks cannot willfully lend without some measure of assurance that loans will be serviced and repaid in a timely manner. Bank balance sheets still carry significant non-earning assets, largely the result of weak financial discipline in the enterprise sector. This will take time to remedy. In the meantime, as long as enterprises experience cash constraints and continue to run up arrears (to banks, enterprises, social funds, utilities, etc.), their debt profiles will not be credit worthy and they will likely be excluded from subsequent credit activity. This will put the onus on the enterprises to restructure and meet competitive standards of productivity, quality and efficiency[10].

Working with IMF figures, the average bank only had about $38 million in outstanding credit at end 2000 and possibly $28 million at end 2001. Again, considering that the two largest banks account for 56 percent of credit, this means the remaining 20 banks average less than $10 million in credit. As a percentage of total deposits, total credit was about 1.35 times total (including Government deposits with banks) at end 2000[11], and 0.56 times at end 2001[12]. As a percentage of net capital, loans were only 2.0 times at end 2000[13], and as low as 1.65 times at end 2001[14]. Thus, banking system ratios appear to be conservative at this point, and suggest that problem loans are now less of a risk to banking system safety than a few years ago. With bad loans still at 27 percent of total, the risk still requires serious monitoring. Nonetheless, recent bank privatizations with strategic investors, corrective actions taken by previously burdened banks, and general efforts to introduce better credit management systems and standards suggest that there is now increased capacity in the system for sound lending. Rising deposits provide additional funding for intermediation, although higher reserve requirements, higher real interest rates, and continued high levels of non-performing loans remain a problem in terms of the cost of lending. The key challenge now is for enterprises to demonstrate their credit worthiness at a time when they face cash constraints due to their high cost structures, relatively low levels of productivity, and lost markets (in some cases) due to recent years of political instability.

10 One of the reasons why this has not occurred in the past has been due to the traditionally preferred method of privatization—management-employee buyouts (MEBOs)—that have generally done poorly throughout the region. For instance, in Bulgaria, MEBOs were also the preferred route. However, they have done so poorly that this method was generally discontinued after 1998. Draft (new) privatization legislation forbids MEBOs in subsequent privatization transactions.

11 $825 million/$610 million = 1.35 times.

12 $618 million/$1,102 million = 0.56 times.

13 $825 million/$404 million = 2.04 times.

14 $618 million/$375 million = 1.65 times.

Table 9: Deposit Money Bank Financing of Government and Enterprises: Stock Figures							
(millions of US$)	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**
Total GDP	4,463	4,261	3,338	3,681	3,236	3,274	3,166
Claims on Government	148	153	33	25	22	111	111
Claims on State Enterprises	166	114	69	199	98	78	53
Claims on the Private Sector	1,032	1,131	915	666	723	636	454
Total Bank Credit	1,346	1,397	1,017	891	842	825	618
Gov't % of Bank Credit	11.0%	10.9%	3.2%	2.8%	2.6%	13.5%	18.0%
SOE % of Bank Credit	12.3%	8.1%	6.8%	22.4%	11.6%	9.4%	8.6%
Private Sector % of Bank Credit	76.7%	80.9%	90.0%	74.8%	85.9%	77.1%	73.4%
Total Bank Credit/GDP	30.1%	32.8%	30.5%	24.2%	26.0%	25.2%	19.5%
Private Sector Share/GDP	23.1%	26.5%	27.4%	18.1%	22.3%	19.4%	14.3%
Notes: 2001 figures are estimates based on September 30 and November 31 figures							
Source: NBRM; IMF; authors' calculations							

Figures from the NBRM (in the table below) suggest that there has been negative net lending since 1999 after an increase of $104 million in 1998. These figures exclude loans to Government (which are included in the table above). Nonetheless, netting out credit to Government along with overdue and non-performing loans, year-end 2000 NBRM figures show credit to be about $400 million, or $18 million per bank. They also show that credit to GDP is about 12 percent, rather than the higher figures reflected in other sources. If so, this would put RM roughly at the level of Albania, Kazakhstan, Lithuania, Moldova, Russia and Ukraine, rather than Bulgaria, Latvia and Belarus[15].

Flow basis figures show the impact has mainly been on the enterprise sector, and by extension, the socially-owned enterprise sector. From 1999-2001, net new credit to the enterprise sector was negative $171 million. Meanwhile, although net credit has declined, households are beginning to obtain more credit. While the figures are modest, households obtained $18 million in net incremental credit from 1998-2001, as compared with a net increase for enterprises of $9 million (due to 1998). In effect, this makes perfect sense, as households are increasing their deposits with banks while enterprises are withdrawing them, and as many of the household credits are more appropriately scaled to the credit limits of banks relative to capital. Moreover, while small loans are administratively more costly to process on a per unit basis, smaller exposures provide banks' portfolio quality with less vulnerability to large exposures. In the event that smaller debtors default, there is also the likelihood with the new legislative framework strengthening creditors' rights that banks would be in a strong position to press their case should a contractual dispute emerge in the case of a default.

[15] This statement must be qualified, as revisions would also have to be made in those cases to ensure measurements followed the same methodology.

Table 10: Commercial Bank Credit to Non-Financial Entities								
	Year-end "Stock" Figures				**Year-end Net "Flow" Figures**			
(millions of $)	**1998**	**1999**	**2000**	**2001**	**1998**	**1999**	**2000**	**2001**
Total GDP	3,681	3,236	3,274	3,166	344	-445	37	-108
Claims on Enterprises	491	359	342	321	180	-132	-18	-21
o/w Local Currency	365	252	263	248	160	-114	12	-16
o/w Foreign Currency	125	107	78	73	20	-18	-29	-5
Claims on Households	40	39	52	51	7	-1	13	-1
o/w Local Currency	40	39	52	51	7	-1	13	-1
o/w Foreign Currency	0	0	0	0	0	0	0	0
Claims on Other Clients	3	3	4	3	1	-1	1	-1
o/w Local Currency	1	2	1	3	-1	1	-1	2
o/w Foreign Currency	2	1	3	0	2	-1	2	-2
Totals	**534**	**400**	**397**	**375**	**188**	**-133**	**-4**	**-22**
o/w Local Currency	**406**	**292**	**315**	**301**	**165**	**-114**	**24**	**-14**
o/w Foreign Currency	**128**	**109**	**81**	**74**	**23**	**-19**	**-27**	**-8**
by Economic Classification								
o/w Enterprises	92.0%	89.7%	86.1%	85.6%	2.4%	-2.4%	-4.0%	-0.6%
o/w Households	7.4%	9.6%	13.0%	13.6%	-22.5%	29.5%	35.0%	4.8%
o/w Other	0.6%	0.7%	0.9%	0.8%	5.4%	7.1%	38.3%	-11.0%
Totals	100.0%	100.0%	100.0%	100.0%	0.0%	0.0%	0.0%	0.0%
o/w Local Currency	**76.1%**	**72.9%**	**79.5%**	**80.4%**	**9.3%**	**-4.2%**	**9.1%**	**1.0%**
o/w Foreign Currency	**23.9%**	**27.1%**	**20.5%**	**19.6%**	**-21.2%**	**13.2%**	**-24.5%**	**-4.0%**
Bank Credit/GDP	14.5%	12.4%	12.1%	11.8%	40.0%	-14.7%	-2.0%	-2.3%
Bank Credit/Assets	49.4%	32.9%	31.0%	22.7%	82.5%	-33.4%	-5.7%	-27.0%
Note: Derived from NBRM figures; 2001 credit figures for September 2001; excludes nonperforming, overdue, provisions; figures are different from IFS figures for private sector								
Source: NBRM; IMF; authors' calculations								

Loan figures show that there is limited credit exposure to active registered enterprises. The Public Revenue Office reported that RM had 25,933 registered enterprises for VAT purposes[16]. (This compares with the Statistical Office that reported that RM had about 100,000 registered active enterprises and trading companies at end 1999. It is uncertain how many of these firms are currently active or registered, particularly as many were also linked through larger holding or trading companies.) The above credit figures translate into relatively small average credit exposure per registered enterprise of $12,378-$19,550 per registered enterprise[17]. While some of the credit to households may actually be for small-scale businesses[18] and would increase the lower bound average, such adjustments would not make a major change in the ratios. For instance, total credit to non-government and non-financial entities that is inclusive of credit to households would still show the average credit to be $14,345 at end 2001[19]. While most

16 See "USAID/Macedonia Fiscal Reform Project", KPMG Barents, January 15, 2002.

17 The range is explained by the differences in the "stock" credit figures used (the numerator) divided by the enterprises registered to pay VAT. The higher $507 million credit estimate for end 2001 is for state enterprises as well as the private sector. The latter includes households, and thus is different from the NBRM credit figures for enterprises only ($321 million).

18 Figures are based on enterprise credit figures, not total.

19 $372 million/25,933 registered enterprises = $14,345.

registered enterprises are very small-scale[20] and did not apply for loans through banks, and average loan exposure is higher than the numbers noted above, general credit exposure relative to registered enterprises is still low. The following table provides a display of RM enterprises by domestic VAT receipts. A second table presents registered firms from 1999 by sector, as well as estimated enterprise average contributions to GDP.

Table 11: Domestic VAT Receipts for October 1, 2000-September 30, 2001

Turnover (denars)	No. of Taxpayers	% of Taxpayers	Net Declared Revenue	% of Revenue
To 1.5 million	12,857	49.58	-17,834,422	-0.06
1.5-10 million	8,559	33.00	390,839,239	13.39
10-25 million	2,149	8.29	471,787,698	16.17
> 25 million	2,368	9.13	2,073,400,769	71.05
Totals	25,933	100.00	2,918,193,284	100.00
Notes: this table is a summary of a larger table that shows 12 turnover bands; net declared revenue negative due to firms with turnover of less than 250,000 denars—all other banks reported positive net revenue				
Source: Public Revenue Office, December 2001 (cited from KPMG Barents report)				

The following table (based on 1999 data) suggests that average enterprise contribution to GDP[21] was greatest in the agriculture and forestry sectors, although this is surprising. The greatest contribution to overall GDP came from manufacturing and mining, although ratios show that the average company in these activities generated about half of contribution to GDP. By sector on an average enterprise basis, this was followed by construction, transport/communications, and other firms (utilities, water management, hotels/restaurants, and real estate). On average, registered enterprises contributed $22,378-equivalent to GDP (prior to net taxes). Converting back to denars, this would mean the average enterprise contributed about 1.35 million denars, which would be close to the median position of taxpayers' declared turnover according to the above table on VAT receipts. In either case, both tables point to relatively low sales levels, which would then point to relatively low levels of cash flow for loan servicing and principal repayment.

[20] Based on public revenue data, 82.6 percent of companies registered for VAT had turnover of less than 10 million denars from October 1, 2000-September 30, 2001. While the economy was adversely affected by political events from April-September 2001, this still shows a low level of reported revenue. Nearly 83 percent of registered firms generated less than $150,000-equivalent in domestic VAT receipts. Nearly half (49.6 percent) of registered firms reported domestic VAT receipts of $22,455-equivalent.

[21] This is broadly defined as value added at basic prices, and is prior to net taxes on production. These figures exclude public administration, education, health, social work, and related community services.

Table 12: Active Registered Enterprise and Trade Company Profile at end 1999								
	By Ownership Status (No. of Firms)						Value Added	
	Social	Private	Coops	Mixed	State	Total	Total ($ mn)	Enterprise ($ actual)
Agriculture/Fisheries/Forestry	118	2,498	290	119	5	3,030	383.2	126,474
Mining/Industry	142	9,974	71	459	6	10,652	636.1	59,720
Construction	53	4,303	154	106	1	4,617	180.3	39,054
Transport/Communications	31	7,992	32	65	3	8,123	285.6	35,160
Trade	324	61,453	330	575	0	62,682	371.0	5,918
Financial	87	5,012	444	161	6	5,710	115.6	20,250
Other	170	10,499	96	134	6	10,905	316.2	28,992
Total	755	91,232	1,321	1,485	21	94,814	2,121.7	22,378
Notes: does not include education, culture, health, social security, or state administration								
Source: Statistical Yearbook of the Republic of Macedonia, 2000; NBRM for GDP figures, adjusted for year-end exchange rates								

B. Asset Quality

Asset quality has been a major problem for RM banks, as reflected in (i) high levels of classified and non-performing loans, (ii) significant provisions for potential losses credit exposures, interest accruals, and off-balance sheet items, and (iii) weak earnings due to the poor performance of assets and high proportion of non-earning assets. Traditionally, Government either intervened directly to encourage banks to provide loans and trade finance products, or to roll over loans, capitalize interest, and engage in other practices that obscured the underlying financial condition of the enterprises and, by extension, the quality of the credit. All of this was acceptable according to the regulatory framework, or was permitted in the absence of effective supervision. Ultimately, these practices culminated in a high concentration of loans to large "socially-owned" enterprises that failed to service and repay according to schedule. As banks had traditionally been owned by these enterprises, their traditional pattern of behavior was to serve as a captive finance company. This led to relatively uncritical approval of loans, particularly as bankers' incentives were to focused on helping shareholder companies meet production requirements, make payroll, etc. Moreover, Government frequently would either provide liquidity support for banks when financing constraints emerged, or later would simply direct credits through preferred banks from funds sourced from donors. The current state-owned Macedonian Development Bank partly plays that role today, although it is intended to operate on a more commercial basis in support of SME exporters. However, prior to 1999, these practices were common. This resulted in insider, connected and generally non-commercial lending practices of banks combined with a culture of non-payment in the socially-owned enterprise sector.

These practices were unsustainable, and non-performing loans at one point reached 31 percent by the end of 1995, equivalent to 112 percent of deposits and 48 percent of capital. Efforts at that point were made to tighten up, and by 1998-99, bad loans had been reduced by about two thirds. However, this surface improvement was fictional, as the figures were based on flawed accounting and inadequate prudential requirements. For instance, loans that today would be classified as sub-standard, doubtful or loss were considered performing with rollovers, interest capitalization, and other tricks to make the credit appear to be performing. By the time more stringent standards were introduced, non-performing loans had increased to about $222 million by end 2000. These figures are substantial when compared with total credit, assets, deposits and capital. They effectively translated into non-earning assets that have the dual effect of weakening returns and driving up the costs of lending. Banks cannot generate needed income from these assets, and capital and liquidity regulations require that banks extend credit on stricter grounds than before. This limits the supply of credit, while prudential compliance and economic reality provide an incentive to banks to charge more on their performing loans to help defray the costs of carrying non-performing loans. Most strikingly, bad loans were about half of banking system capital at end 2000. Netting out these figures, this would bring the average bank down to about $8.3 million in capital, barely above the minimum required[22]. This suggests that several smaller banks may not comply with requirements if loan portfolios are put to strict quality tests.

NBRM figures at end 2000 showed that 39 percent of total bank credit was "C", "D", or "E", meaning sub-standard, doubtful, or loss[23]. Doubtful and loss loans amounted to 24 percent of total, not much different from the 27 percent figure used in other sources. The table below provides a profile of impaired assets in the banking system and their potential effect if they had to be written off.

Table 13: Estimated Impaired Assets

(in US$ millions)	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**
Total GDP	4,463	4,261	3,338	3,681	3,236	3,274	3,166
Total Assets	1,497	1,543	1,277	1,081	1,216	1,279	1,654
Bank Credit	1,346	1,397	1,017	891	842	825	618
Bad Loans	414	303	215	69	79	222	167
Bad Loans/Total Credit	30.8%	21.7%	21.1%	7.8%	9.4%	26.9%	27.1%
Bad Loans/Total Assets	27.6%	19.6%	16.8%	6.4%	6.5%	17.3%	10.1%
Bad Loans/Total Deposits	112.4%	93.0%	66.7%	17.2%	16.9%	41.8%	18.2%
Bad Loans/Net Capital	47.5%	33.2%	31.6%	21.7%	20.0%	54.9%	44.7%
Bad Loans/GDP	9.3%	7.1%	6.4%	1.9%	2.4%	6.8%	5.3%

Notes: bad loans for 2001 are all overdue claims as of September 30, 2001, which may understate the actual amount of non-performing loans

Source: IMF; NBRM; EBRD; authors' calculations

III. EARNINGS TRENDS AND RECAPITALIZATION

Based on the poor quality of assets and limited range of financial services provided by the banks, earnings for the banking sector have been predictably weak for several years. Indicators of these weaknesses are shown in low net interest margins due to weak loan quality, high dependence on interest from loans due to limited alternative income sources, and very low after-tax profits manifesting themselves in poor ROA and ROE figures. Even relatively low levels of operating

22 Minimum capital is now Euro 9 million, about $8 million-equivalent. If $222 million in non-performing loans were charged off against $404 million in capital, this would leave $182 million in capital $182 million/22 banks = $8.3 million, barely above the Euro 9 million minimum requirement.

23 "Sub-standard", or "C", generally applies to loans that are 31-90 days overdue. "Doubtful", or "D", generally applies to loans that are 91-180 days overdue. "Loss", or "E", generally applies to loans that are more than 180 days overdue and there is justified expectation that the debtor will not repay the claim.

expenses are negative due to the manual orientation of many banks, underdeveloped systems, and the inability to provide more than very basic services. This is expected to change in the coming years with strategic foreign investors. However, this will take time.

Table 14: Profit/Loss Indicators and Adjustments for Provisioning

(US$ millions, %)	1997	1998	1999	2000
Interest Income	73	105	80	78
Interest Expense	36	41	44	39
Net Margin	37	64	36	39
Other Income	82	85	92	77
Other Expenses	92	123	60	60
Net Provisions for Losses (US$)	6	16	57	44
Taxes (US$)	0	1	3	2
After-tax Profits/Losses (US$)	21	9	8	10
Interest Income/Total (%)	47.0%	55.1%	46.4%	50.3%
NIM/Avg. Assets (%)	2.6%	5.4%	3.1%	3.1%
General Admin. & Other/Costs (%)	43.4%	37.7%	26.8%	32.0%
ROA (%)	1.5%	0.8%	0.7%	0.8%
ROE (%)	2.7%	1.8%	2.3%	2.4%
Adjusted Provisions for Losses (US$)	215	69	79	222
Adjusted After-tax Profits/Losses (US$)	-188	-44	-14	-168
Adjusted ROA (%)	-13.3%	-3.8%	-1.2%	-13.5%
Adjusted ROE (%)	-23.6%	-8.9%	-4.0%	-42.0%

Notes: Adjusted provisions reflect difference between actual net provisions and total bad (non-performing) loans

Source: NBRM; IMF; EBRD; authors' calculations

The figures presented in the table include adjustments for provisions if bad loans were to be fully provisioned. While this may be excessively conservative, it demonstrates that the thin profits reported by the banks over the years may, in fact, be losses. Adjusting provisions to reflect the difference between actual net provisions and total bad (non-performing) loans, banks would have shown $443 million in losses from 1997-2000, rather than $48 million in after-tax profits.

While the depths of losses may not be so great as this adjustment, NBRM has recognized that the bulk of its banks and related assets were troubled by 1999. The main banking sector culprit was Stopanska Bank. By the time Stopanska was privatized in 1999, its market share accounted for 35 percent of assets and 40 percent of deposits. Thus, Stopanksa was the nerve center in many ways for the RM economy, financing the largest socially-owned enterprises, handling their deposits, and responding to Government incentives (e.g., directed lending, budgetary and off-budget funding) to boost output, preserve jobs, and handle a range of transactions. However, with mounting losses in the SOE sector and comparable increases in non-performing loans and other bad/overvalued assets, the Government was forced to sell Stopanska. Other troubled banks have required forbearance during a three-year period to recapitalize their balance sheets and meet prudential requirements.

The introduction of effective prudential controls after 1999 has helped with the financial restructuring process. Banks are now better capitalized, with CARs on the order of 37 percent. NBRM has been monitoring banks' solvency and liquidity positions, as well as placed restrictions on banks during corrective periods until CARs have reached certain thresholds. While NPLs remain high, they are recognized. Thus, at a minimum, the underlying financial condition of the banks has improved since 1999, while privatization and strategic investment have increased prospects for competition and modernization.

Progress was beginning to show in 2000, as deposits in the system increased, and net spreads on loans by banks came down from a real average of 9.2 percent from 1996-1999 to 7.1 percent in 2000. However, these spreads remained high, more than double typical spreads founding the Euro-zone. Moreover, net spreads have again increased in 2001 due to tighter reserve requirements and continued high levels of NPLs. The high net spreads have been maintained and increased for banks to recapitalize, because there is greater risk in the marketplace due to internal disorder, and because banks are in a strong position (e.g., "sellers market") to drive the terms of loan agreements. The following table shows rates and spreads in RM since 1995.

Table 15: Nominal and Real Net Interest Spreads							
(end of period*; all in %)	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**
NBRM Discount Rate	15.0%	9.2%	8.9%	8.9%	8.9%	7.9%	10.7%
Deposit Rate	24.1%	12.8%	11.6%	11.7%	11.4%	11.2%	10.3%
Net Differential	-9.1%	-3.6%	-2.7%	-2.8%	-2.5%	-3.3%	0.4%
Loan Rate	45.9%	21.6%	21.4%	21.0%	20.4%	18.9%	19.8%
Deposit Rate	24.1%	12.8%	11.6%	11.7%	11.4%	11.2%	10.3%
Net Differential	21.9%	8.8%	9.8%	9.4%	9.1%	7.7%	9.5%
Real Loan Rates	39.5%	21.0%	21.2%	20.9%	20.7%	17.3%	19.9%
Real Deposit Rates	20.7%	12.4%	11.5%	11.6%	11.5%	10.2%	10.3%
Real Net Spreads	18.8%	8.6%	9.7%	9.3%	9.2%	7.1%	9.5%
Inflation Rate (CPI annual average)	16.4%	2.7%	1.1%	0.5%	-1.3%	9.2%	-0.3%
Notes: real rates discounted by average CPI; interest spreads between denar and foreign currency deposits reportedly 6-7%							
Source: IMF; NBRM; World Bank; authors' calculations							

Because of the emphasis on safe investments for compliance with liquidity and capital adequacy requirements, financing of Government has become more important for banks since 2000. Prudential requirements set capital adequacy at a minimum of 8 percent. Investment in T-bills is assigned a zero risk weight, whereas lending is assigned risk weights of 20 to 100 percent. Thus, banks are required to have greater amounts of absolute capital to assume credit risk in the enterprise sector, while lower capital makes it feasible to generate earnings from safer investments in Government securities. However, the trade-off has been that earnings from these securities have been relatively low. As the Government's fiscal position has been stable[24] and even in surplus in 2000[25], and its debt profile is moderate[26], the Government does not have significant financing needs from the banking system. In fact, the central Government significantly increased its deposits with the banks, permitting the latter to pay down foreign debt. Thus, in the absence of alternatives, commercial bank financing has largely amounted to placement of funds

[24] Fiscal deficits have not exceeded 1.8 percent of GDP since 1995.

[25] This is due to revenues generated from the newly introduced VAT that exceeded budgetary expectations. See "Memorandum of Economic and Financial Policies", IMF, November 15, 2000.

[26] External debt-to-GDP was only 43 percent at June 30, 2001 and 39 percent at end 2001. Projections initially showed that RM was not expected to exceed 51 percent by 2003. See "Memorandum of Economic and Financial Policies", IMF, November 15, 2000. More recent figures are from NBRM and the "Memorandum of Economic and Financial Policies", IMF, December 24, 2001.

in safe but relatively low-yielding securities, both in RM as well as in the Euro-zone. The limited bank financing of Government is shown below.

Table 16: Commercial Bank Financing of Government Expenditure

(millions $, %)	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**
Total GDP	4,463	4,261	3,338	3,681	3,236	3,274	3,166
Fiscal Deficit/GDP	-1.0%	-1.4%	-0.4%	-1.8%	0.0%	1.0%	-2.8%
Fiscal Deficit	-45	-60	-13	-66	0	33	-90
Claims on Gov't	148	153	33	25	22	111	111
Claims on SOEs	166	114	69	199	98	78	53
Total Bank Credit	1,346	1,397	1,017	891	842	825	658
Gov't % of Total Bank Credit	11.0%	10.9%	3.2%	2.8%	2.6%	13.5%	16.9%
SOE % of Total Bank Credit	12.3%	8.1%	6.8%	22.4%	11.6%	9.4%	8.1%
Credit to Gov't & SOEs/Bank Credit	23.3%	19.1%	10.0%	25.2%	14.1%	22.9%	25.0%
Credit to Gov't & SOEs/GDP (%)	7.0%	6.3%	3.0%	6.1%	3.7%	5.8%	5.2%
Credit to Gov't & SOEs/Deficit (%)	-703.2%	-2342.3%	-7614.9%	-1343.9%	0.0%	2519.1%	-730.0%

Notes: 2001 fiscal figures from NBRM in November and then annualized; GDP is nominal zero percent growth from 2000 NBRM figure; 2001 credit figures from NBRM for September 30

Sources: NBRM; IMF; EBRD; authors' calculations

ANNEX 2: BANKING SUPERVISION AND DEPOSIT INSURANCE

Scott Trapani is responsible for the contents of Annex 2. The Annex was produced as part of a larger assessment for USAID as it moves forward to consider new initiatives in its ongoing efforts to strengthen bank and non-bank financial institutions in the Republic of Macedonia. Information for this assessment was obtained during an on-site visitation by KPMG/Barents advisors from January 16, 2002 through January 29, 2002.

I. Overview of the Banking Sector

The most recent annual data (year-end 2000) showed the banking system of the Republic of Macedonia consisting of 22 commercial banks and 19 savings houses. The Macedonian banking system is concentrated in a few banks, with the five largest banks holding 72.4% of the total net assets of the banking system of the Republic of Macedonia. The assets of three banks account for 64% of the total assets of the banks, while the largest bank alone covers 35.8% of the total assets of the banks in the country.

The process of privatization of banks in the Republic of Macedonia continues. As of the end of 2000, the level of privatization of the banks was approximately 88 percent. Foreign capital accounted for roughly 41% of total banking capital. Foreign investors held stakes in 16 banks, at a level ranging between 0.3% to 100 percent. Banking companies are highly concentrated in the capital city of Skopje. Of the total number of financial institutions, only six banks and five savings houses are headquartered outside of Skopje, with most of the other regions being serviced through a wide branch office network.

The break-up of former SFR Yugoslavia brought about a "freezing" of foreign currency saving deposits in all the republics of the Federation. The Republic of Macedonia, as well as the other republics, experienced an enormous drop in confidence in banks and savings houses. One of the measures undertaken to restore the confidence of the public in the banking system was the establishment of Insurance Fund. In accordance to the Law on Banks and Savings Houses, the Saving Deposit Insurance Fund Inc. was set up in January 1997 as a joint shares holding company by the banks and savings houses, with the aim to provide a guarantee for the savings deposits of individuals up to a given level. In July 2000, a stand-alone law on the Deposit Insurance Fund was enacted followed by the establishment of the Deposit Insurance Fund in November 2000 as a public institution and a legal successor of the Saving Deposit Insurance Fund Inc.

Confidence in the banking system appears to be strengthening as confirmed by the fact that during the period from its establishment until today, total deposits made by the population in the members of the Fund have experienced a growth of 208 percent.

II. Banking Supervision Assessment

The National Bank of the Republic of Macedonia ("NBRM") was established as an independent Central Bank on April 26, 1992. The NBRM is independent and responsible for the stability of the national currency (Denar), monetary policy, general liquidity of payments within the Republic of Macedonia and abroad and financial stability of a banking system as a whole.

The NBRM is comprised of two managing bodies - the Council of the National Bank of Macedonia ("Council") and the Governor of the National Bank of Macedonia ("Governor"). The Council is responsible for managing the operation of the NBRM concerning proposals and implementation of the monetary and foreign exchange systems and monetary and foreign exchange policies.

The Governor is responsible for passing instructions for the uniform implementation of regulations and decisions of the Council. The Governor also manages and organizes the operations of the NBRM to carry out its responsibilities. Currently, the NBRM is organized into fourteen separate division with the NBRM Supervision Department ("Supervision") reporting directly to the Governor. The supervisory functions of the NBRM were established under Section 6, Articles 47-60 of the National Bank of the Republic of Macedonia Act (the "Act"). The Act was most recently revised in 1998 and gives the NBRM broad regulatory and supervisory authority regarding banking activity.

Supervision is divided into six functional units as follows:

1. Onsite Supervision Unit;
2. Offsite Supervision Unit;
3. Methodology Unit;
4. Conversation, Monitoring and Enforcement Unit;
5. General Supervisory Affairs Unit; and
6. Regulatory Enforcement Unit.

All of the above units work in a team environment in the ongoing supervision of the banks. Total staffing within Supervision consists of 35 specialists, with the bulk of personnel assigned to the Onsite and Offsite Units.

The following assessment of the NBRM's supervisory function is based on discussions held with Supervision staff during our diagnostic visit. Meetings were held at the NBRM to discuss Supervision's development of onsite and offsite capabilities, enforcement actions, methodology and other general supervisory areas. The purpose of this diagnostic is to identify areas of strength and weakness, and to present recommendations for the strengthening of these functions. The initial assessment of the NBRM's supervisory capacity was made in conjunction with the Basel Core Principles for Effective Bank Supervision as outlined in the September 1997 correspondence.

The Basle Accord is comprised of twenty-five basic principles that need to be in place for supervisory system to be effective. The principles relate to:

- **Preconditions for Effective Banking Supervision** - Principle 1
- **Licensing and Structure** - Principles 2 to 5
- **Prudential Regulations and Requirements** - Principles 6 to 15
- **Methods of Ongoing Banking Supervision** - Principles 16 to 20
- **Information Requirements** - Principle 21
- **Formal Powers of Supervisors** - Principle 22, and
- **Cross-Border Banking** - Principles 23 to 25.

The Basel Core Principles are intended to serve as a basic reference for supervisory and other public authorities in all countries and internationally. The Principles have been designed to be verifiable by supervisors, regional supervisory groups, and the market at large.

This assessment will be organized under the seven broad areas outlined above and will incorporate a review of the outstanding laws and regulations governing Macedonian banks and bank supervision, and how these factors conform to the Core Principles.

A. *Preconditions for Effective Banking Supervision*

As is usually the case, much of the preconditions are either missing or are currently under development in Macedonia. Many of these preconditions are outside the control of banking supervisors, but still have a direct and significant effect on their ability to discharge their duties. In accessing the overall banking supervision environment, the following factors are part of the fundamental framework:

- sound and sustainable macro-economic policies;
- a well developed public infrastructure;
- effective market discipline;
- procedures for efficient resolution of problems in banks; and
- mechanisms for providing an appropriate level of systemic protection.

As said earlier, many of these factors are outside the control of the NBRM Supervision Department, but they still have a large impact on regulatory effectiveness. If the Macedonian government firmly commits to pursue sound domestic economic policies, and domestic financial institutions would be more likely to follow basic principles of sound banking. Lenders would charge borrowers interest rates that reflect true credit risk and require proper collateral, prudent investment decisions, and sound domestic economic policies as conditions for cross-border loans. Lenders would also enhance their own internal risk-management systems, which have been characterized as one of the most effective countermeasure to the increased potential instability of the global financial system.

1. *Conclusion*

NBRM's Supervision Department appears to have made significant progress in addressing those areas that are within its control. Supervision has developed a clear, achievable and consistent framework of responsibilities and objectives as stipulated in the law. Staffing, while light (35 full-time personnel) has been sufficient to meet objectives. The NBRM has adopted a comprehensive set of banking laws and regulations that sets out minimum standards that banks must meet; and which gives supervisors a wide range of corrective tools. Supervisors also appear to be protected legally while discharging their duties.

2. *Recommendations*

Areas that need to be strengthened as part of the preconditions for effective bank supervision are:

- *Full Adoption of Internationally Accepted Accounting and Disclosure Practices* - The full-adoption, and implementation, of internationally accepted accounting practices by foreign and domestic businesses would allow Macedonian lenders to more accurately assess the true credit risk of potential borrowers. Capital markets reward "transparency" and the adoption of uniform standards by providing better terms to borrowers that use accepted accounting practices.

- *Free and Undistorted Capital Markets* - The primary function of a free capital markets is the ability to lend to liquidity-constrained, yet creditworthy, borrowers at interest rates that reflect true credit risk. Borrowers generally act more responsibly with funds borrowed from private creditors than with funds borrowed or placed by domestic governments or donor agencies. Borrowers that default on private loans are often excluded from private capital markets for a decade or more. Market discipline constrains reckless behavior. While Macedonia is making progress in its development of a functioning capital markets, legal, social and political obstacles remain. The Macedonian stock Exchange currently has three listed companies and there is strong reluctance by companies to list, as this would disrupt ownership structures. Currently, the exchange (especially the third market exchange) is being used by various parties to change controlling interests in various companies. Individual shareholders are discouraged, by management, from selling their shares and most shareholders have given their voting rights to management. The SEC office in Macedonia works primarily with disenfranchised stockholders who wish to sell their stock, but are being forced to agree to prearranged schemes by senior management of their firms. Many issues need to be addressed by the local capital markets operate as a true conduit of funds.

- *Fundamental Institutional Reforms* - Economic development requires the accumulation of physical, human, and financial capital. A secure and predictable environment attracts capital. Capital will flee countries with excessive taxation, inflation, regulation, trade and investment barriers, government intervention, political corruption and instability. It will avoid countries lacking creditor, stockholder, and private property rights or well-defined banking, commercial, and bankruptcy laws. Unfortunately, Macedonia lacks many of these basic institutional ingredients for self-sustaining economic growth. Progress is being made on many of the fronts, although slowed by the instability that occurred in 2001.

Basle Core Principles recognize the fact that banking supervision is only part of wider arrangements that are needed to promote stability in financial markets. It is difficult, if not impossible, to have an effective banking supervision function without a basic economic and social framework conducive to the growth of a market-based banking industry. Elements of this framework include sound and sustainable macro-economic policies, a well-developed public infrastructure, effective market discipline, procedures for efficient resolution of problems in banks, and mechanisms for providing an appropriate level of systemic protection.

B. Licensing and Structure

Basle Core Principles 2-5 requires that the permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined. The licensing authority must have the right to set criteria and reject applications that do not meet the standards set. The licensing process should consist of an assessment of the banking organization's ownership structure, directors and senior management. Banking supervisors must also have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties. In addition, supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

1. *Conclusion*

The NBRM Supervision Department has the right to set criteria for licensing banks and these criteria are consistent with those applied in ongoing supervision. It also has the right to reject applications if the criteria are not fulfilled or if the information provided is inadequate. The Banking Law allows for two separate types of banking licenses and mandates minimum capital requirements for each structure. Background checks are made, to the extent possible under Macedonian law, on all proposed managers and directors. If progress is made in interagency communication, the NBRM's ability to screen foreign applicants will be greatly enhanced. Proforma financial information is requested and reviewed, but the quality of accounting data varies. The Banking Law defines what types and amounts of acquisitions and investments need supervisory approval and criteria by which to judge individual proposals is provided. The Banking Laws also defines for which cases notification after the acquisition or investment is sufficient.

2. *Recommendations*

The NBRM is largely compliant with most of the principles covered in this area, with a few notable exceptions. Based on the data received from Supervision, further clarification on the status and function of savings associations is needed to define their permissible activities under the recently revised Banking Law. Of more serious concern is the confusion created by the poorly conceived levels of ownership that are allowed before supervisory approval. Under the current law, shareholders acquiring 10% or less of the outstanding (or initially issued) voting shares of a bank do not have to receive prior approval from the NBRM. However, the law does not effectively deal with related entities or collusion issues, thus multiple parties could each acquire 9.9% of the voting issue and effectively control the bank. If this weakness is combined with the NBRM's current inability to investigate both the proposed investor (foreign or domestic) and the true source of the funds used in the investment, a serious threat to the financial integrity of the Macedonian banking sector could develop. In this type of emerging market, the qualifications and integrity of owners and investors of financial institutions are paramount. Therefore, the NBRM is in serious need of assistance in drafting and revising laws to close these areas of weakness.

C. *Prudential Regulations and Requirements*

This area is covered under Basle Core principles 6-15 and requires banking supervisors to set prudent and appropriate minimum risk-based capital adequacy requirements. Supervisors must also put in place a system to evaluate a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios. Management information systems must also be examined to ensure their capabilities to identify concentrations within bank portfolios and the adherence to supervisory prudential limits regarding exposures to single borrowers or groups of related borrowers. To prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks. Supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control country risk, market risk and transfer risk, and supervisors should have powers to impose specific limits and/or a specific capital charge on any exposures, if warranted. Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict "know-your-customer" rules that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.

1. Conclusion

The NBRM Supervision Department has made significant strides in establishing minimum risk-based capital requirements, and current standards largely mirror Basle requirements. Article 30 of the Banking Law requires all banks and savings houses to calculate and consistently maintain a minimum guarantee capital to risk-weighted asset ratio of 8 percent. The Law also allows Supervision to require higher minimum levels, but places an upper boundary of 16 percent on these requirements. Articles 85 and 86 of the Banking Law give Supervision clear authority to take corrective measures should a bank fall below the minimum capital ratio. For banks whose capital adequacy ratio is less than three-quarters of the required minimum of 8%, Supervision requires that the bank adopt a recapitalization plan approved by its shareholders and by the NBRM, and, if necessary, agree to asset growth restrictions, investment restrictions, and/or insider lending restrictions..

Articles 54-65 of the Banking Law place explicit requirements on bank management bodies including the formulation, adherence and revision of lending and investment policies. The Law mandates the development of adequate policies and procedures, but should be expanded to include minimum standards for operating policies.

Classification standards are set forth in accordance with Article 31 and 33 of the Banking Law and Article 65 item 30 of the National Bank of the Republic of Macedonia Act. On June 28, 2001, the Council issued an amended decision on the methodology to be used when determining on-balance sheet and off-balance sheet classifications. This directive also incorporates country and market risk factors. In brief, the directive establishes five credit quality bands (A-E) with a loan classified as an "A" credit having the highest credit quality. The directive also establishes mandatory reserve calculations based on the assigned risk classification – "A" credits with 0%, "B" credits 10%, "C" credits 25%, "D" credits 50%, and "E" credits with 100% reserves. This system complies with Basle standards and provides supervisors sufficient leeway to exercise independent judgment.

The directive also establishes an optional 2 percent general reserve against "A" credits, and this is a welcomed development in this type of market. Recent directives have established sound criteria for the supervision of large credit exposures and related lending arrangements. Country and transfer risk criteria however, are not adequately covered under existing legislation. Market risk, a component of the CAMELS rating system has yet to be implemented by the NBRM Supervision Department. This is an important are that needs to be addressed, especially in light of the instability in the current financial system. Risk management systems in banks have yet to be fully developed and a lot more effort is needed to strengthen internal processes. There has been very good progress made on the establishment of internal routines and control procedures and the policies put in place are compliant with Basle standards. Money laundering procedures are considered very weak and are the major focus of our recommendations in this area (see below).

2. Recommendations

There are four areas where significant efforts are necessary for the NBRM to achieve compliance regarding the establishment of prudential regulations and requirement – namely in the areas of country risk, market risk, bank operational risk, and money laundering efforts. Each of these areas will be discussed below:

a) Country Risk

Supervision needs to develop onsite methodologies to assist examination staff in determining if a bank's policies and procedures adequately address country risk and transfer risk exposures. Bank policies should address minimum and maximum exposure ranges by individual entities and for countries as a whole. The NBRM should also ensure that banks have developed a risk management reporting system to ensure that country risk exposures are identified during normal operational activities. The NBRM may also wish to set various regulatory exposures limitations by country. In addition, the NBRM should draft a directive instructing banks to submit on a routine basis country risk exposure data to the central bank so that systemic risk can be monitored.

b) Market Risk

Given current conditions in Macedonia, the banking sector is faced mainly with exchange rate risk, but market risk factors continue to increase. Domestic capital markets, while still in the infancy stage, will grow and will expose bank balance sheets to market risk. This scenario is still a ways off, but the NBRM should be developing policies and procedures to encompass these risk factors.

c) Other Operational Risks

These risks, as outlined under Basle Principle 13, are related to the implementation of comprehensive risk management systems in banks and savings associations. Such systems should be able to identify measure, monitor and control material risks such as liquidity risk, interest rate risk, and operational risk. Supervision should begin to develop standards related to these risks, especially concerning the types of assets deemed to be "liquid." Most of these guidelines can be developed as supervisory directives without having to quantify them in actual regulation.

d) Money Laundering Efforts

This area is covered under Basle Principle 15. In July 2001, the Law on Money Laundering was passed, but it has yet to be implemented. The law, as drafted, covers most of the Basle minimum standards, but it is at the bank level where intensive efforts will be required to ensure that the law has its intended effect. Realistically, the ownership structure of most Macedonia banks is unclear and, in some case, highly questionable. Money laundering efforts, while important, cannot overcome structural issues as their effectiveness generally rests on the compliance of management. When management is of questionable character, laws are only the first step.

D. Methods of Ongoing Banking Supervision

According to Basle Core Principles, an effective banking supervisory system should consist of some form of both on-site and off-site supervision, and there must be clear and continuous contact between supervisors and the regulated institutions. As part of this communication process, supervisors must develop data collection systems to enable the analysis of financial data. The validity of this data needs to be confirmed – generally through the onsite examination function or external audit reports. The final part of this process is the ability to analyze related banking groups and affiliated companies.

1. Conclusion

The NBRM's compliance with core principles 16-19 is considered strong. The onsite and offsite supervisory functions are well organized, well integrated, effective and staffed with strong and committed personnel. Onsite examination staff performs inspections on an 18-month rotation cycle, modified according to risk assessments. The level of integration between the onsite and offsite staff is strong. Between examinations, offsite analysts monitor the condition and trends in the various institutions and produce both monthly and quarterly assessments. Offsite reports use a CAEL rating system and incorporate trend analysis. Each report is focused on the suitability of the previously assigned onsite CAMEL rating, and if deterioration or improvement is noted, the information is incorporated into the examination planning process. Prior to onsite examinations, both onsite examiners and offsite analysts meet to discuss risk areas and use this information to scope out examination priorities. After the onsite inspection, the lead examiner will report his conclusions to committee comprised of onsite management, offsite analysts, and legal staff. Each rating is presented and, if necessary, defended. The report is finalized after a consensus is reached. This entire process is enhanced due to the NBRM's decision to staff offsite positions with seasoned personnel that have experience in onsite examinations.

This type of arrangement greatly enhances the credibility of the offsite function and allows for clear communication between the units. Based on the limited scope of our analysis, the banking supervision function of the NBRM was considered excellent.

2. Recommendation

NBRM needs to expand its focus in the area of consolidated supervision. This is a difficult area to develop now given the absence of formal banking groups in the Macedonian system. Informal groups or alliances are extremely hard to monitor due to the restrictions on gathering information from shareholders. As noted elsewhere in this report, shareholders owning or controlling 10% or less of outstanding voting shares are not currently required to receive prior supervisory approval. Therefore, if an informal group of six individuals or entities each purchase 9.9% or less of a bank's voting shares, de facto control has been established without the notification or approval of the supervising authorities. The NBRM has recently developed regulations that allow the formation of defined banking groups, but has yet to draft a policy outlining procedures pertaining to consolidated supervision.

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It is recommended that the NBRM draft such a policy and that it incorporate a supervisory framework that evaluates the risks that non-banking activities conducted by a bank or banking group may pose to the bank or banking group. If necessary, additional regulations should be drafted to ensure that Supervision has the legal authority to review the overall activities of a bank, whether the activities are conducted directly (including those conducted at overseas), or indirectly, through subsidiaries and affiliates of the bank. Supervision must also have the authority to impose prudential standards on a consolidated basis for the banking organization, and to limit the range of activities the consolidated banking groups may conduct.

E. *Information Requirements*

This area is covered under Core Principle 21 and requires banking supervisors to ensure that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices. This information will allow the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business. Principle 21 also requires banks to publish, on a regular basis, financial statements that fairly reflect its condition. This condition is an aid to transparency and is related to the prerequisite conditions discussed previously.

1. *Conclusion*

Supervision has the authority to hold bank management responsible for ensuring that financial record keeping systems and the data they produce are reliable, and that supervisor-required reports are submitted on a timely and accurate basis. Information from bank records is verified periodically through NBRM onsite examinations. External audits standards have been established and can accept or reject submitted audit reports.

2. *Recommendations*

While overall compliance in this area is strong, there is still a need for the implementation of, and adherence to, International Accounting Standards. While the NBRM is doing what it can to ensure accurate and timely information, they are not equipped to, nor responsible for, audit at the transaction level. Bank auditors, both internal and external, should be insisting on this issue of accounting transparency. However – Macedonia has not reached the level of shareholder involvement that would result in demands for greater transparency. This area, with assistance from donor agencies, will evolve, but it will take time.

F. *Formal Powers of Supervision*

Core Principle 22 relates to the establishment and use of corrective powers by banking supervisors. It requires supervisors to have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet regulatory requirements. These powers should also include the ability to revoke banking licenses.

1. Conclusion

Article 85 of the NBRM Banking Act provides a wide range of corrective powers that are available to Supervision. These powers range from informal memorandums to revocation of licenses and removal orders against management bodies and individuals. There are also directives on the use of civil money penalties. Other Articles within the Act describe, in significant detail, the receivership and liquidation processes to be used if corrective actions are not effective in bring about required changes.

2. Recommendations

During our discussion with Supervision management, there appears to be a need for more active involvement by the Managing Boards of banks and savings houses in the implementation of formal and informal corrective actions. As this is generally a new process in this market, these changes should evolve through the normal course of operation. The NBRM is spearheading initiatives to increase communication between regulators and banking officials. This increased awareness of supervisory responsibilities should help in this matter. No other areas of weakness were noted.

G. Cross Border Banking

This area is covered under Basle Core Principles 23-25 and relates to the internationally active domestic banks, interagency communication between regulatory officials in various countries, and requirements that foreign banks operate in accordance with domestic prudential regulations. This area has direct linkage with the concept of "consolidated" supervision as outlined under Core Principle 20, with the focus on international affiliations versus related domestic groups.

1. Conclusion

Although many of these concepts are not applicable in the present Macedonian environment as there are no domestic banks with international activities, there are signs that this issue will grow in importance in the near future. Foreign investment in banks, while currently small, is growing. As ties with other countries grow, so will the need to monitor international banking activities. This is also true regarding the identification of ownership issues discussed earlier, as well as international money laundering efforts. As such, the NBRM has stated the need to strengthen its regulatory framework in this area.

2. Recommendations

Regulations need to be strengthened to ensure that Supervision has the authority to supervise the overseas activities of locally incorporated banks. While the ability to gather information on local operations is clearly set forth in the Act, additional regulations concerning foreign branches and subsidiaries will need to be drafted. Directives will also need to be written outlining the role of bank management in maintaining proper oversight of the bank's foreign branches, joint ventures, and subsidiaries. Procedures will also need to incorporate review procedures to endure that local management of any overseas offices has the necessary expertise to manage those operations in a safe and sound manner.

As these regulations develop, a key component that will need to be addressed is the establishment of good working relationships with other banking supervisory agencies. This will facilitate the sharing of information, not only on banking activity, but also on ownership structures and sources of capital. There is an immediate need for such information due to the NBRM's current inability to monitor foreign ownership and the sources of investment capital flowing into the Macedonia banking system.

Finally, the issue of foreign bank compliance and adherence to domestic regulations has largely been achieved. NBRM regulations and directives are adequate in scope and there are no readily apparent areas of weakness in oversight.

H. *Summary Conclusions*

Based on the limited scope of this assignment, the overall condition of the Macedonia banking supervision function is strong. Given the relatively short development period, prudential regulations are comprehensive and broad enough to ensure effective oversight capabilities. The onsite examination function is well conceived, timely, and staffed with motivated personnel. Offsite capabilities are also strong, given the limited availability of information. CAEL scoring models are in use and offsite data is incorporated into the examination planning process.

Onsite and offsite integration and cooperation was surprisingly advanced and effective. A lot of this success can be traced to the decision to establish an independent offsite unit that focuses of purely quantitative analysis, but that is staffed with analysts that were formerly senior onsite inspectors. This decision has led to an atmosphere of cooperation and respect between the units, while maintaining the distinction between onsite work and the offsite analysis process.

I. *Summary Recommendations*

Based on the above assessment, future assistance should be directed towards the enhancement of regulations especially in the areas of market risk and money laundering. There is also a pressing need to draft regulations and procedures on the definition and approval of ownership structures, as well as the tracing of funds being invested into the Macedonian banking sector. While recommendations have been made under each section above, the following are the most pressing issues presently facing the system and are the areas in need of more immediate assistance:

- The Supervision Department is in immediate need of short-term legal consultation on how to amend existing regulations concerning regulatory approval of ownership structures. Article 11 of the NBRM Banking Act states that *"for gradual or one-time acquisition of shares, regardless of whether they are acquired by one or more affiliated persons, whose total cumulative nominal value is 10%, 20%, 33%, 50% and 5% of the total shares with managing right, prior approval must be granted by the National Bank."* As written and enforced, individuals or entities that acquire 9.99% of the voting shares are not required to obtain prior approval from the NBRM. As discussed previously, the law is also ambiguous in its definition of related entities. These factors, combined with the NBRM's limited abilities to investigate domestic and foreign investors, and to trace the source of the invested funds, has led to severe concerns as to bank ownership structures. This area is directly related to domestic and donor agency desires to increase NBRM surveillance capacity regarding money laundering. Based on these weaknesses, there is a strong need for donor assistance in reviewing and drafting regulations in these areas. Based on our assessment, the assistance would be short-term in nature (3-6 months) and would be working directly with the Supervisions legal, enforcement and onsite supervision units.

- There is also a need for short-term technical assistance in the drafting and implementation of consolidated supervision methodology as required under Basle Core Principles 21, 23 and 24. Ideally, such assistance should be given after the restructuring of the legal requirements described above as this would a prerequisite for this type of assistance. The assistance should be focused on training on consolidated supervision methodology including the analytical techniques used to evaluate the financial capacity and condition of banking groups and related organizations. Training should also be given on cross-border analysis.

- In conjunction with Recommendation #2, there is a need for a much higher level of training concerning Country Risk (Core Principle 11), Market Risk (Core Principle 12) and Operational Risk (Core Principle 13). Donor assistance is needed primarily in training, again assuming that the legal assistance has been completed. Based on our conversations with Supervision staff, the greatest area of uncertainty, and the area that needs to be addressed to implement the new "S" component in the CAMELS rating system, is the concept of market Risk. Given the embryonic nature of the Macedonia capital market structure, there is little understanding as to potential risks other than exchange rate risk. However, increased foreign investment, and the development of domestic capital market instruments is changing this environment. Again, assistance in this area should be short-term in nature and focused on formal training.

Most of the above recommendations are related to short-term training issues and it is important to emphasize the need for domestically relevant training. Standard Basle Principle courses, while somewhat effective, will not be as effective as training materials based on the unique characteristics of the local Macedonian market. There are factors in the market that make standard or template training ineffective and will likely be poorly received. I suggest that technical assistance be focused on advisors either that have resided in this country before, or who will live in Macedonia on a short-term basis during the entire development of the training materials. That is the best way to ensure that the materials prepared are based on local realities versus vague academic theories.

III. The Deposit Insurance Fund of Skopje

A. *Profile*

The Deposit Insurance Fund of Skopje (the "Fund") was established in January 1997 under the name Savings Deposit Insurance Fund Inc., Skopje, pursuant to the then valid Banks and Savings

Houses Act. Since March 2001, the Fund is a state institution named Deposit Insurance Fund Skopje and is the legal successor of the Savings Deposit Insurance Fund Inc., Skopje.

The Fund is managed by the Managing Body that consists of five members – 3 members from the Ministry of Finance, one member representing the NBRM, and one member from the Banking and Insurance Association. The director and all board members are appointed by the government of the Republic of Macedonia.

The following deposits of individuals are insured by the Fund:

- Denar and foreign currency deposits of individuals in banks and savings houses,
- Deposits backing money cards issued by domestic, banks established in the Republic of Macedonia, and
- Foreign currency inflow of individuals in banks in the Republic of Macedonia.

Article 10 of the Law of the Deposit Insurance Fund excludes the following types of deposits from protection:

- Deposits of individuals with privileged terms of interest, other than those announced in the bank or savings house.
- Deposits of individuals owning more than 10% of the voting shares in the bank or savings house;
- Deposits of members of managing bodies of the bank or savings house;
- Deposits of relatives of the individuals stated in lines 2 and 3 of the relevant article in the Charter, including spouses and children.

With recent changes, the Fund provides insurance up to 100% of the deposit of each individual in a bank or savings house not exceeding the amount of Denar equivalent of Euro 3,000 and 90% of the deposit of each individual in a bank or savings house not exceeding the amount of denar equivalent between Euro 3,000 and 10,000, but not more than a denar equivalent of Euro 10,000.

1. Conclusion

Currently, there are 17 banks and 15 savings houses that are members of the fund. Each member institution pays an annualized premium of 2.5% of its average deposit base. Assessments will stop when the fund's balance reaches 5% of insured deposits. The most recent data indicates that the fund is close to a 4% funding level.

Since inception of the Fund has been involved in two direct payouts of insured deposits – Uni Prokom Savings House in 1999, and Almako Bank in 2000. There activities and related information is shown in the following table:

YEAR	Total Bank/Savings House Failures	Deposits held in Failing Banks	Total liability of the Fund		Payments	
		in '000 Denars	In Denars (000)	In DEM (000)	In Denars (000)	In DEM (000)
1997	0	-	-	-	-	-
1998	0	-	-	-	-	-
1999	1	7.728	5.003	161	4.774	154
2000	1	2.850	1.785	58	17	1
2001	0	-	-	-	12	1
Total:	2	10.578	6.788	219	4.803	156

Nearly 71% of the deposits held in the banks qualified for insurance reimbursement and all monies have been paid to depositors.

2. *Recommendations*

The deposit insurance system in the Republic of Macedonia is unique for an emerging market in that it has been tested and it works. When the two banking failures occurred as shown above, there were no major disruptions in the system – exactly the outcome one would hope for in this type of situation. The Fund was well conceived at inception, is well managed, and is well funded. However, two areas need to be addressed:

- Current deposit exclusions need to be eliminated, as they are poorly conceived and ant-competitive. Firstly, to exclude deposits that are receiving an arbitrarily defined "privileged" rate of interest is not proper and cannot be supported. Presently, under a liquidation scenario, any deposit that exceeds the average rate on those types of deposits could be considered privileged and excluded. To track when those funds were received, under what rate environment etc., is an enormous undertaking and is counterproductive. While in these types of markets, it is easily understood why you would try to discourage "privileged" rates of interest, it is not a feasible exclusion in a deposit insurance system. In addition, this would not allow a sound, well-managed bank from doing short-term promotions to attract funds, as no depositor would risk losing insurance protection under this scenario.

- Secondly, to exclude the deposits of significant shareholders (those with 10% or more of the voting stock) is unfair and unproductive to the system as a whole. Controlling shareholders in any country generally are individuals and entities with money – hence, if the system is in need of fund (and this is in desperate need in Macedonia) to exclude classes of individuals with funds is not sound policy. The same holds true for members of the managing board. Generally, board members are people of means and these are the people needed by the current banking system. To exclude managing board members and all their immediate relatives is ill conceived. We should be striving for increased involvement by board members, not discouraging it through unsound regulation.

- The other issue that needs to address is the Fund's need for information. Currently, the fund operates as a payment "box" and is not a proactively involved participant. The Fund needs to increase the flow of information between the NBRM Supervision Department and itself. This is not to say that the fund necessarily needs supervisory authority, but it should have a voice in the decision making process and not treated as merely a funding source. This is a delicate endeavor, but based on the abilities of both Fund and Supervision personnel, it is doable.

ANNEX 3: SECURITIES AND EXCHANGE COMMISSION IOSCO ASSESSMENT

Scott Trapani is responsible for the contents of Annex 3. The Annex was produced as part of a larger assessment for USAID as it moves forward to consider new initiatives in its ongoing efforts to strengthen bank and non-bank financial institutions in the Republic of Macedonia. Information for this assessment was obtained during an on-site visitation by KPMG/Barents advisors from January 16, 2002 through January 29, 2002.

I. Overview

The Securities and Exchange Commission of the Republic of Macedonia (MSEC) with its headquarters in Skopje was established by a Decision of the Government of the Republic of Macedonia on June 19, 1992. The MSEC is an autonomous and independent organisation with a status of a legal entity, and is comprised of a president and six members. Its mission is to regulate and supervise all participants in the Macedonia securities market. The MSEC is in charge of the implementation of the Securities Law and the Investment Fund Law, as well as all other regulations passed on basis of these two laws.

According to Article 159 of the Securities Law, the President and members of the Commission shall be appointed and dismissed by the Parliament of the Republic of Macedonia, at a request of the Government of the Republic of Macedonia.

The Securities Commission performs the following functions:

- Undertakes measures to secure the implementation of this Law and other laws within its competence;
- Passes acts or rules derived from this Law and other laws within its competence;
- Undertakes measures to ensure the implementation of such acts or rules passed in accordance with this Law and other laws within its competence;
- Undertakes measures required for the protection of interests of persons who are owners or who invest in securities and prevent dishonest and illegal activities related to trading in securities;
- Issues approvals arising from this Law and other laws within its competence;
- Regulates the method of trading with securities on the Stock Exchange and Over the Counter Market;
- Monitors and controls the activities of brokerage houses and banks in their dealings with securities, as well as authorized investment management companies i.e. investment funds;

- Performs inspection over the operations of the Central Depository of Securities;
- Prescribes standards of competition among brokerage houses and banks in their dealings with securities, as well as authorized investment management companies i.e. investment funds, by inspections or in another manner;
- Grants approvals for appointing and releasing managers from duty regulated in Articles 80, 110 and 132 of this Law as well as managers in investment funds management companies regulated in the Law on Investment Funds;
- Approves public invitations regarding public offer of securities;
- Ensures legal, fair and transparent securities market;
- Approves the rules of the securities market related to listing of securities and the obligations for disclosure and periodical financial statements of listed companies;
- Co-operates with other institutions in and outside the Republic of Macedonia through exchange of information and in other ways;
- Passes acts or rules for the internal organisation of the Commission; and
- Performs other activities related to the operations with securities and in accordance with this Law.

II. IOSCO Objectives and Principles of Securities Regulations

Principle 1: The responsibilities of the regulator should be clear and objectively stated.

Assessment – Broadly Observed. The Securities Law does set forth the agencies responsibilities in a fairly clear manner, but this is a new agency and a new function. It will take some time before a clearer picture on the needs of the market and investor can be made.

Principle 2: The regulator should be operationally independent and accountable in the exercise of its functions and powers.

Assessment – Broadly Observed. The SEC does operate independently, but there are certain limits given the political realities of emerging economies.

Principle 3: The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.

Assessment – Broadly Observed.

Principle 4: The regulator should adopt clear and consistent regulatory processes.

Assessment – Not Observed. This is in flux as laws are being amended and drafted. The regulatory process will change as laws are set in place.

Principle 5: The staff of the regulator should observe the highest professional standards, including appropriate standards of confidentiality.

Assessment – Not Observed. Only limited interaction with personnel was available during the assessment period.

Principle 6: The regulatory regime should make appropriate use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence and to the extent appropriate to the size and complexity of the markets.

Assessment – Not Observed. This has not been put in practice to date, but there is a framework being developed.

Principle 7: SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.

Assessment – Not Observed.

Principle 8: The regulator should have comprehensive inspection, investigation, and surveillance powers.

Assessment – Broadly Observed. During discussions with the Commission Director Tomovsky, the inspection and investigation powers of the SEC are in place. Surveillance powers are under development.

Principle 9: The regulator should have comprehensive enforcement powers.

Assessment – Broadly Observed.

Principle 10: The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance, and enforcement powers and implementation of an effective compliance program.

Assessment – Not Observed.

Principle 11: The regulator should have authority to share both public and nonpublic information with domestic and foreign counterparts.

Assessment – Broadly Observed.

Principle 12: Regulators should establish information sharing mechanisms that set out when and how they will share both public and nonpublic information with their domestic and foreign counterparts.

Assessment – Not Observed.

Principle 13: The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers.

Assessment – Broadly Observed.

Principle 14: There should be full, accurate, and timely disclosure of financial results and other information which is material to investors' decisions.

Assessment – Not Observed. The Macedonian accounting industry has not implemented IAS regulations and procedures to any great extent.

Principle 15: Holders of securities in a company should be treated in a fair and equitable manner.

Assessment – Not Observed. Corruption, manipulation and unequal treat is widely seen in this market. It will take an estimated 3-5 years to make any noticeable improvement in this area. Cultural and social issues will impede the process.

Principle 16: Accounting and auditing standards should be of a high and internationally acceptable quality.

Assessment – Not Observed.

Principle 17: The regulatory system should set standards for the licensing and the regulation of those who wish to market or operate a collective investment scheme.

Assessment – Broadly Observed.

Principle 18: The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.

Assessment – Broadly Observed.

Principle 19: Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.

Assessment – Not Observed. Framework is under development.

Principle 20: Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and redemption of units in a collective investment scheme.

Assessment – Not Observed. Still under development, but preliminary regulations have been drafted.

Principle 21: Regulation should provide for minimum entry standards for market intermediaries.

Assessment – Broadly Observed. The law does have standards, but implementation is just beginning.

Principle 22: There should be initial and ongoing capital and other prudential requirements for market intermediaries.

Assessment – Broadly Observed.

Principle 23: Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients and under which management of the intermediary accepts primary responsibility for these matters.

Assessment – Not Observed.

Principle 24: There should be a procedure for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.

Assessment – Not Observed. The law in this area is weak and needs to be amended.

Principle 25: The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.

Assessment – Not Observed.

Principle 26: There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.

Assessment – Not Observed.

Principle 27: Regulation should promote transparency of trading.

Assessment – Broadly Observed.

Principle 28: Regulation should be designed to detect and deter manipulation and other unfair trading practices.

Assessment – Broadly Observed. This is a major problem in this fledgling market and occupies a lot of the agency's time.

Principle 29: Regulation should aim to ensure the proper management of large exposures, default risk, and market disruption.

Assessment – Broadly Observed.

Principle 30: The system for clearing and settlement of securities transactions should be subject to regulatory oversight and designed to ensure that it is fair, effective, and efficient and that it reduces systemic risk.

Assessment – Broadly Observed. Regulations currently under amendment and should be strengthened soon.

III. Macedonian IOSCO Objectives and Principles Observance

Principles	Practice	FO 1/	BO 2/	NO 3/	Comments
Principles Relating to the Regulator (1–5)	The Macedonia Securities and Exchange Commission (MSEC) is independent and has adequate powers and resources to be effective. However, laws are being rewritten and amended to make them more applicable to the domestic environment. There is a very great need to have integrated legal reform in this country as changes in some areas are not being discussed with affected parties..		X		See above.
Principles of Self-Regulation (6–7)	Process not place, but framework is under development.			X	
Principles for Enforcement of Securities Regulation (8–10)	The MSEC has adequate enforcement power as it is permitted to revoke licenses. These powers are not very well known in the industry and have not been tested.		X		
Principles for Cooperation in Regulation (11–13)	Not Obsereved during assessment.			X	
Principles for Issuers (14–16)	Based on discussion with Director Tomovsky, this is an area of serious weakness in the system.			X	
Principles for	The Law on Investment		X		

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Collective Investment Schemes (17–20)	Funds is broadly written and allows for the development of open-end funds, closed-end funds and unit trusts.				
Principles for Market Intermediaries (21–24)	The Law on Securities, including recent amendments, provides the legal basis for market intermediaries. These are with EU requirements.		X		
Principles for the Secondary Market (25–30)	While the Central Depository is in place, there are a lot of problems in ensuring that accurate shareholder records are submitted. In addition, legal precedent is unavailable on this issue. Other areas were compliant with standards		X		

Source: USAID assessment.

1/ FO: Fully observed.
2/ BO: Broadly observed.
3/ NO: Not observed.

ANNEX 4: THE INSURANCE AND PENSION SECTOR

Stewart Kemp is responsible for the contents of Annex 4, which he wrote as part of a financial sector assessment conducted by KPMG-Barents Group. The assessment was performed to feed into USAID's ongoing efforts to strengthen bank and non-bank financial institutions in the Republic of Macedonia. Information for this assessment was obtained primarily during an on-site visit from January 16, 2002 through January 26, 2002.

SECTION 1: DESCRIPTION OF THE INSURANCE INDUSTRY IN MACEDONIA

Overall Market. At present four insurance companies are domiciled in the Republic of Macedonia. According to data provided by the Insurance Supervision Department, annual premium volume of the four insurers totaled 5.5 billion MKD ($84 million US) in 2000. This figure was down slightly from 5.6 billion MKD in 1998 and 6.0 billion MKD in 1999. Gross profit in 2000 was 57 million MKD, down from 300 million MKD in 1998 and 273 million MKD in 1999. The loss ratio for the industry (on a paid rather than incurred basis) has been about 60%, with 1999 the best of the three years. Total assets have grown from 8.5 billion MKD in 1998 to 11.2 billion MKD in 2000, while capital has grown from 2.3 billion MKD to 2.9 billion MKD during the same period, resulting in significant improvement in the industry's premium-to-surplus ratio. The data provided do not break down the experience by line of insurance.

QBE Macedonia. The largest by far of the four Macedonian insurers is Insurance QBE Macedonia. This company is the former state-owned insurer, ADOR or ZOIL Makedonija, which was founded in 1945. It was privatized in 1999 and acquired by QBE Insurance Group of Australia in March, 2000 (although we were told that AIG came within a week of acquiring the company but withdrew as a result of the hostilities in Kosovo). QBE Insurance Group owns insurance companies in other countries in the region (Hungary, Bulgaria, Slovakia, Ukraine, and Moldova). At present QBE is approximately 65% owned by Australian investors, 15% by the state-owned pension fund (as a result of requirements for privatization), and 20% by others, primarily its employees. It presently has approximately 1000 employees. As shown in Table 1, it accounts as of 2000 for approximately 90% of the national premium volume, although we are told that this market share is expected to decline slightly for 2001 in light of growth of the new, smaller companies. QBE provides industrial property, civil property, transport, motor vehicle, and agricultural insurance. It provides a limited amount of liability insurance, including aviation hull and liability. It also insures the property of the Electricity Supply Companies with a special gross premium tariff. QBE alone of the four Macedonian insurance companies issues life insurance policies.

Based on discussions with the company, several areas of organizational and business development appear to have been required once privatized. Management was not as strong as anticipated, and substantial training of personnel was needed. It was necessary to terminate the former General Manager, who had been accustomed to running the company without supervision. A number of older employees have since been replaced with younger employees, and they have made up in attitude what they lacked in experience. They are also less accepting of certain traditional practices that are considered undesirable for a market-based insurance firm. Certain practices from the earlier state-owned have been serious problems, and not all of them have been fully resolved. One has been for the company to carry non-paying policyholders for lengthy periods of time, retaining the obligation to pay claims despite the absence of premium payment (until deducted from the claim payment), and resulting in pressure to write more such business in order to maintain levels of written premium. Macedonian laws have reportedly made cancellation for non-payment difficult and lengthy. Another problem area has been the practice of payments of sums of money as special commissions or rebates in connection with the placement of business, including types of payments that would not be acceptable under Western standards. QBE has stated as a matter of policy that they would not make under-the-table or other improper payments, although it would pay a proper broker's commission by check where appropriate and properly documented. A third problem area has apparently been abuse with respect to claims, including alleged corruption in the judiciary. A fourth problem area has been reported political influence in banking and insurance, including diversion of customers for reasons other than price, strength of the company, and quality of service. Despite certain Macedonian patterns and practices, QBE claims to be committed to conducting its business in accordance with proper Western standards.

Despite the transitional problems encountered, especially bad debts resulting from non-payment of premiums, QBE made a profit for 2001, although it reflected reserve take-downs rather than operating profits. The year 2002 is expected to be a year of special challenge for the company, a make-or-break year. Management is streamlining operations, including reducing the number of employees in both administration and sales; improving training of personnel; improving service, especially to major customers; upgrading claim adjustment procedures; and reducing the amount of its bad debt.

The company has voiced concerns about the new insurance law pending in Parliament. This has been described it as a draconian approach to insurance regulation, although it appears to be compliant with European Union standards. With regard to pending legislation, the company has two main points of concern: the authority of the Minister of Finance to approve members of the management board, and the effective date of June 30, 2002. The company has expressed concern that that power could be used for political purposes and impede sound management, and that the June 30 deadline was too soon and would require QBE to expend resources too quickly to achieve compliance. QBE would have to devote developmental resources to compliance instead, and that in order to meet the June 30 deadline, to some extent it would have to make the compliance changes twice, once quickly and a second time properly. Thus, QBE has recommended that the effective date be six months later, December 31, 2002. QBE noted that the standards in the new law would still apply to financial statements for 2002, but that there would not be a risk of an on-site examination in the second half of 2002 looking for non-compliance, with a risk of license revocation.

QBE described the Head of the Insurance Supervision Department as one of the better regulators in the region. However, there are concerns that her lack of experience in the insurance industry has affected her ability to understand the operational impact of some changes required by the law. For example, she thought that a company could re-do asset allocations in a day, while QBE's view is that it would take much longer to complete that task thoroughly and accurately.

In summary, the uncertainties facing QBE are in several areas: the issues of the Albanian minority, and potential hostilities; the outcome of elections in the spring; the condition of the economy; and the continuation of certain Macedonian practices. For the company itself, challenges are in the areas of reducing the level of bad debt; improving service; improving claim adjustment procedures; training personnel; improving efficiency of administrative personnel; improving productivity of sales personnel; and finding and retaining good local managers to operate the business.

Vardar. The second largest insurer is AD Vardar Skopje. Originally founded in 1968 as a small subdivision of ZOIL "Jugoslavija", it developed as a branch of ZOIL "DUNAV" from Belgrade.

When Macedonia became independent in 1993, it became a shareholder-owned company, AD Vardar Skopje. At that time approximately 60% of the outstanding shares of stock of the company were owned by its employees; we are told that today that figure is 84%. (Apparently this increase results from the sale of shares by non-employee stockholders, as no new shares have been issued to employees since the 1993 conversion of the company.) Two companies own 4% each of the shares, while others own on the order of 2% each. Shares of Vardar, including those owned by employees, may be sold on the Macedonian stock exchange. The price has apparently been fixed since 1993 at 100 DM per share.

Vardar's market share is approximately 8%, and approximately 60% of its business consists of motor vehicle coverage. More than 80% of its business is "civilian" as opposed to "institution", which we take to mean business. It also provides property coverage, including fire (both commercial and residential), goods in transit, agriculture, and a small amount of liability insurance. Its annual premium volume has increased from approximately 9 million DM in 1996 to 14.2 million DM in 2000, with additional growth of approximately 4 million DM in 2001. The company's loss ratio for 2000 was 57.5%, and it earned a gross profit of 320,000 DM for that year. As shown in Table 2, premium volume has been projected to increase substantially for 2001. This table provides a detailed breakdown of the company's writings. It shows that the substantial majority of the business (especially property insurance) is written for legal entities rather than physical persons.

According to discussions with Vardar, the company operates at the edge of profitability, with motor vehicle insurance more profitable than property insurance some years, and the opposite other years. Last year, the company had paid a dividend at the rate of 7.5% on its shares, although in some years the rate had been higher. However, the company was struggling with non-payment of premiums because of current adverse economic conditions. The company is reluctant to cancel long-term policyholders and would continue to provide coverage if non-payment happened only once or twice, in hopes that the policyholder – especially commercial – would return to economic health. In some cases, Vardar has accepted shares of stock of a delinquent commercial policyholder in lieu of cash.

Claims are usually settled without dispute, with a very low percentage of complaints. The company estimates that fewer than 3% of the claims went to court, with most disputes relating to motor vehicle coverage. The company is concerned that some lawyers had connections with police to learn quickly about car crashes. The company has also expressed concern about possible corruption in the courts, where cases are apparently often decided very unfairly to the company. A significant amount of fraud and cheating takes place; one example is where the theft of the contents of a truck had been staged.

Vardar invests its assets primarily in bank accounts, which it spreads among five banks. It owns only a small amount of stocks and bonds. It maintains its assets in denar and is not permitted to hold foreign currency for any significant period of time. Because of the high inflation rates experienced in the 1980's, the company is concerned that the return of inflation would erode the value of its investments. The largest problem faced by Vardar today is the severe weakness of the economy. Not only does this weakness undercut its current business, by both loss of policyholders and non-payment of premiums, but it precludes opportunities for growth. The company has also expressed concern about the pending insurance law, especially its provisions for approval of members of the management board by the Minister of Finance. The General Manager, Mr. Kiopcevski, is an attorney by training, and has been with Vardar for 22 years. He became the General Manager in 2000.

Tabak and Makoshped Insurance Companies. These two companies were founded in 1993 and 1995, respectively, and are owned by Macedonians. As of 2000, each of them accounts for just over 1% of the national premium volume. We are told that their rates of growth on a combined basis exceed the national average, with the result expected that their respective market shares will increase slightly. From 1999, Tabak's premium volume fell by about 20% while Makoshped's grew by more than 50%. From 1998 to 2000 Makoshped's premium volume more than doubled, while Tabak's declined by about 20% over that two-year period. Like Vardar, they write only non-life coverages, apparently primarily property abd motor vehicle insurance. Makoshped has 11 employees while Tabak has 20. Tabak's writings increased 67% during the second half of 2001. Tabak focuses on business property insurance.

Makosphed was founded by, and is largely staffed by, former QBE employees. A quarter of its stock is owned by a related industrial company with the same name. Only one employee, the General Manager (who had 20 years experience at QBE), owns shares. The remainder are owned by approximately 20 persons and entities. Makosphed has a serious problem with uncollected premiums, with collection efforts underway for about 10% of its accounts. The company enjoys a 95% renewal rate, indicating satisfaction with its quality and service. It targets small and medium-size business enterprises. The company has expressed concern about both general economic conditions and hostilities. The company is making special efforts to avoid writing business where risks are high, especially crisis regions. The company's volume grew 5% in 2001 compared with 50% the preceding year, but that it made a profit in 2001. While tariffs were generally used, companies could compete by reducing the allowance for administrative expenses. The ace in Makosphed's sleeve is reported to its low level of administrative expenses, which enabled it to price its policies competitively. The company is now interested in writing compulsory motor vehicle insurance, which it had avoided before, because the rates were now higher.

The company hailed the establishment of the insurance supervision department, which management believes should be in place in Macedonia. The company feels that regulations are needed and that the regulators are doing a very good job, although they would benefit from additional experience. The value of regulatory prevention is emphasized by this company, catching problems when they were still small and manageable. With respect to the new law, the company believes that it is generally good but that the companies need more time – an additional six months – to implement it. The company stresses the importance of improvement in economic conditions and avoidance of hostilities to build a strong future for the insurance industry in Macedonia. Management also believes that it is important to raise the level of professionalism in Macedonia.

Tabak Insurance emphasized that their company was growing. Management said that Tabak attracted clients from other companies by offering better economics, trust, better organization, and different approaches to clients who had had difficulties with other carriers, primarily QBE. They indicated that the company had a detailed marketing strategy. They said that they selected employees who invested love and energy in the company. They reported a significant problem with uncollected premiums, but said that the company had earned a profit in 2001. They said that they expected foreign insurers to enter the Macedonian market. They indicated that their recent on-site examination by the Insurance Supervision Department had gone well, although they needed to make certain changes, which they declined to identify. When asked about the new law, they said that it was so complex that they could not comment on it in an interview of the length and nature that we were having. They terminated the meeting after less than one hour. During the meeting – in contrast to meetings with the other three Macedonian insurers – they seemed hesitant, guarded, and nervous. Most of their answers to questions were very vague. They asked repeatedly what the purpose of the interview was.

Rate-Setting. Tariffs for compulsory motor vehicle insurance and other lines are set by insurers and made available collectively by a trade association, the National Insurance Bureau, with the approval of the regulatory authorities. The tariffs, which include the allowances for claims but not acquisition and administrative expenses, are apparently published in the newspaper. There is some variation of rates among the four companies on the basis of differing expense allowances. QBE is typically the most expensive. A major problem is the high number of drivers who are uninsured. The proportion of uninsured drivers, which has apparently increased during the recent hostilities, is estimated to be 25% or more. Rates for other coverages apparently vary relatively little among the companies. Rates for coverages other than motor vehicle are filed with the regulator but apparently not challenged. We understand that any new entrants into the market would be able to charge lower rates if they wished. Almost all reinsurance of the three smaller companies is placed with QBE.

Life Insurance. Life insurance premiums account for about 1.6% of overall premiums in the industry. Only one company, QBE, writes this line; its writings, however, increased from 61.4 million MKD in 1998 to 88.5 million MKD in 2000, even though its premiums overall declined from 5.3 billion MKD to 4.9 billion MKD during that period. As a result of the very high inflation rates experienced in the 1980's, there is apparently little faith in life insurance among the Macedonian public. The General Manager of Vardar told us that until 1988 that company had 40,000 life insurance policies. He said that the high inflation rates extinguished life insurance. He added that he wished that Vardar could sell life insurance in order to grow. The head of the Insurance Supervision Department, Aleksandra Naceva, attributed the paucity of life insurance to prior problems of frozen assets as well as the low standard of living in the country and lack of investments available for life insurance companies.

SECTION 2: DESCRIPTION OF THE INSURANCE SUPERVISION DEPARTMENT OF MACEDONIA

The Insurance Supervision Department of Macedonia was established in the fall of 2000. It is situated within the Ministry of Finance. It is headed by Aleksandra Naceva, a 27-year-old woman with a background in mathematics and economics. Until two months ago, the staff consisted of Ms. Naceva and three others, a lawyer and two economists. A mathematician and a third economist have recently been hired, bringing the total complement to six. There is not a support staff. Ms. Naceva is a knowlegeable and hard-working leader of what appears to be a dedicated and committed group of young regulators.

The Department has been involved, with technical assistance from Germany, Slovenia, and Estonia, with the development of the new insurance law, which is expected to be enacted by Parliament within a matter of days. This new law, which is comprised of more than 250 articles, is a major step forward for insurance regulation in Macedonia. The new law includes numerous technical provisions and will impose many duties on the Department. Its implementation poses a great challenge to the new and small insurance department. Most immediately, the Department will be required to draft and promulgate 24 by-laws (implementing regulations) under the law. In addition, it will be responsible for enhanced financial surveillance, licensing of companies and brokers, on-site financial and market conduct examinations, and enforcement.

The Department has already undertaken its first on-site examinations, of Tabak and Makoshped, and will produce detailed reports of examination. It has also for the first time created a data base for the entire insurance industry; this data base includes all balance sheet data. Previously, the only insurance data available was that included in the annual reports submitted by the companies. The Department has also produced three by-laws, relating to the solvency margin for life insurance, the solvency margin for non-life insurance, and procedures for applications to and actions by the Department. Ms. Naceva noted that the inclusion in capital of two reserve accounts, relating to catastrophes and prevention, raised issues of adequacy of capital and accurate presentation of taxable income for Macedonian insurers.

Ms. Naceva indicated that the Department is open to the public, but she indicated that it was not available as a forum for the resolution of disputes relating to claims. She said that the Department's objective was to build confidence about insurance in the members of the public and to enhance the awareness of insurance as a provider of security. She added that she hoped that under the new law new entrants would come to Macedonia; she emphasized that the Department would welcome major foreign insurers, and that there was no discrimination against foreign insurers. She explained that the minimum capital requirements for new insurers had not been increased under the new law but, with the separation of different lines of insurance in the licensing requirements, had been reduced for those insurers that wished authorization for fewer lines of insurance. She also noted that the Department undertook enforcement actions. She mentioned that an unregistered company, Tam Insurance Company, had been found to be operating without a license but that her office had brought a halt to its operations.

Ms. Naceva commented that the Department would benefit from assistance in technical areas, such as licensing procedures for brokers and certification procedures for actuaries. She noted with concern that there was at present only one actuary in Macedonia, who was more than sixty years old, and questioned what would happen if he died. She added that the Department would benefit from financial support for membership and participation in the activities of the International Association of Insurance Supervisors.

SECTION 3: REVIEW OF NEW INSURANCE LAW OF MACEDONIA

The new Law on Supervision of Insurance in Macedonia is comprised of 252 Articles. It is an unusually thorough and detailed. It is expected to be enacted by Parliament within a few days. It will almost totally supersede the prior insurance laws and will provide a framework for regulation for the foreseeable future.

Articles 1 through 11, General Provisions (Section 1), specify the reach of the law, the types of insurance undertakings that are subject to it, and definitions of the various classes of insurance. This section includes the application of the law to foreign as well as domestic insurance undertakings. Chapter 1 of Section 2 sets forth the standards for incorporation of insurance undertakings. As well as referencing the minimum capital standards set forth later in the law, the law (Article 16) limits the holdings of any individual stockholder to not more than 25% of the shares of the insurer. This chapter also sets forth limitations for the acquisition of shares of an insurer by a third party. In addition, it sets forth requirements for the functioning of the managing body of the insurer and of its supervisory body.

Section 3 of the law governs the incorporation and operation of the insurance undertaking. The first requirement specified is licensure. Application procedures as well as documentary requirements are included. This section also includes detailed provisions governing the issuance of the decision to grant or deny a license. Procedures are also set forth as to the licensing of outsourcing activities and transfer of insurance portfolios to other insurers.

Chapter 3 of the law governs the performance of insurance activities outside of Macedonia. The law distinguishes between activities in a member country and a foreign country. In order to conduct operation s in a member country, the insurance undertaking must give prior notice to the Ministry of Finance concerning the insurance activities to be conducted and, if applicable, the address and responsible persons at a branch office to be located there. The Ministry of finance shall supervise the operations of the Macedonian insurer in the member country or request the relevant supervisory body of the member country to do so, and that body shall be informed in any event. To conduct operations in a foreign country, the Macedonian insurer must obtain a license and establish a branch office.

Chapter 4 provides that insurers from member countries may conduct operations in Macedonia, either directly or through a branch office, on notification to the Ministry of Finance. Although the supervisory body of the member country shall continue to supervise the activities of the insurer in Macedonia, the Ministry of Finance shall have authority to impose a ban on the issuance of new insurance policies.

Chapter 5 provides that foreign insurers may conduct operations in Macedonia only through branch offices and with a license from the Ministry of Finance. Requirements include posting a deposit in a separate account to cover liabilities arising from policies covering Macedonian exposures and complying with a detailed list of requirements (although the law exempts Swiss insurers from some of them).

Section 4 of the new law, captioned "Risk Management", governs capital requirements for insurers. It provides for the inclusion of certain types of capital, such as paid-up shares and retained earnings, but excludes others, such as stocks owned by the insurer and long-term intangible assets, from basic capital. Insurers are required to set aside in a safety provision one third of profits until the safety provision equals one half of the average premiums collected over the preceding two years. The chapter also limits the proportion of assets that may be invested in certain asset classes, such as real estate, stocks, and bonds.

Articles 75 and 76 set forth detailed formulas for the calculation of solvency margins for both life and non-life carriers. Article 77 sets forth minimum "guarantee fund" amounts varying with the classes of insurance issued that the insurer must maintain. The following articles include requirements for establishing reserves with respect to both unearned premiums and claims, whether or not yet reported to the insurer, including actuarial provisions. Chapter 4, beginning at Article 86, requires insurers to maintain assets at levels sufficient to cover required reserves. It includes general requirements as to diversification and management of investment risk, and it enumerates fifteen classes of permitted investments. It also prescribes limitations in the percentage of assets that may be invested in certain asset classes, and it proscribes certain asset classes altogether. Chapter 5 includes additional rules applicable to assets set aside to meet so-called "mathematical provisions".

Chapter 6 sets forth rules governing reinsurance carried by Macedonian insurers, including the determination of maximum permitted retention. It sets standards for maintenance of liquidity, adherence to statistical standards, quarterly monitoring of capital, solvency margin, reserves, asset valuation, and investments. This chapter includes prohibitions against dividend payments under specified circumstances, and requires management to maintain adequate solvency margins and report actions taken to the Ministry of Finance. Section 5 requires insurers to maintain personal data on a confidential basis, with certain limited specified exceptions. Article 109 sets forth types of data that insurers must maintain in organized data bases.

Articles 110-116 set forth provisions relating to certified actuaries and the tasks that they are to perform. They include standards for certification, a requirement that licensed insurers appoint a certified actuary, prohibitions against conflicts of interest, and requirements for actuarial certification of the insurer's annual accounts, including calculation of premiums and adequacy of reserves.

Section 7, beginning at Article 117, requires insurers to maintain detailed books of account in conformance with applicable requirements. It requires insurers to submit annual reports to the Ministry of Finance certified by both an actuary and an auditor. Each insurer is also required to maintain an independent internal audit unit reporting directly to the managing board of the company. This unit is required to perform a complete supervision of the company's operations to verify that it is conducting its operations in compliance with the law. This section includes detailed provisions as to the procedures to be followed by this unit and the contents of its reports, which must be made twice each year, as well as reporting procedures (including to the Ministry of Finance if breaches of the risk management rules or threats of insolvency are found).

Section 10 of the law governs agents and brokers. Agents need not be licensed, but the law (Article 134) states directly that an insurance undertaking shall be held liable for the activities of an insurance agent. Chapter 2 of this section, however, includes detailed procedures and standards for the licensing of insurance brokers. Included are disclosure requirements as to potential "clashes of interest", commission limitations, licensing requirements, and supervision requirements by the Ministry of Finance.

Section 11 of the law sets forth the basis for supervision of insurance undertakings by the Ministry of Finance. The duties include off-site supervision by collecting and analyzing data and reports. In addition, the Ministry has the authority to direct insurers to eliminate violations and to withdraw licenses and order liquidation of insurance undertakings. The law also sets forth procedures in the event of bankruptcy, including the degree of applicability of the Bankruptcy Law and priorities of claims. The law includes special provisions relating to claims for payments relating to assets covering mathematical reserves and the appointment of curators. The law also includes provisions relating to discontinuance of unlicensed insurance undertakings.

Section 12 of the law provides for procedures for issuing decisions by the Ministry of Finance. These procedural provisions include on-site supervision procedures and processes for eliminating violations of the law, including filing objections. Also included are procedures for the issuance of decisions and revocation of licenses.

Section 13 of the law governs insurance and reinsurance pools. It directs and sanctions the formation of the National Association of Insurers. Section 14 sets forth the permitted activities of the association, including the establishment of a guarantee fund.

Section 15 sets forth procedures for cooperation by the Ministry of Finance with other supervisory bodies within the European Union. These provisions include the responsibility of the Ministry of Finance to inform other supervisory bodies of any significant obstacles faced by the insurance undertaking active in foreign countries, as well as the responsibility of the Ministry to respond to requests made by European supervisory bodies.

Section 16 of the law provides for penal provisions. For 18 major violations, fines of 250 to 300 million MKD are established. Fines of 45 to 50 million MKD are also authorized for individuals within an insurance company who are responsible for any of the enumerated offenses. Fines are also authorized for members of the managing or supervisory boards of an insurance company. In addition, brokers, auditors, and actuaries are subject to fine as well.

Section 17 of the law sets forth transitional provisions. A six-month period from enactment is provided for existing insurers to come into compliance with the law.

SECTION 4: COMPARISON OF IAIS CORE PRINCIPLES WITH MACEDONIAN INSURANCE LAW

This section compares the core principles of the International Association of Insurance Supervisors ("IAIS"), as stated in the Joint Forum release dated November 7, 2001, with the new Macedonian law on insurance. First are stated the IAIS core principles, followed by the corresponding references to the new Macedonian insurance law.

IAIS: Effective insurance supervision requires a set of preconditions to be in place. While these preconditions are largely beyond the control of the supervisory authority, weaknesses or shortcomings in these areas may significantly impair the ability of the supervisory authority to implement the Core Principles effectively. The preconditions cover a range of areas, including i) a well-developed public infrastructure; ii) procedures for the efficient resolution of problems in insurance companies; iii) effective market discipline; and iv) sound and sustainable macroeconomic policies.

The public infrastructure may have a profound effect on a jurisdiction's ability to implement the insurance Core Principles. The legal system is the foundation of the financial system, which ensures the honouring and enforcement of insurance contracts. An adequate infrastructure also requires that accounting standards be comprehensive, internally consistent and approach international best practices, so that investors and supervisors can properly evaluate the financial conditions of the insurance companies, and the insurance companies can assess the health of the institutions that they lend to or invest in. The development of insurance products and sound financial management, in particular the calculation of technical provisions (policy liabilities), requires a strong actuarial profession. Accurate financial data requires qualified experts including accountants, auditors and financial analysts. Other key considerations in evaluating the public infrastructure are the effectiveness of supervision in other financial sectors and markets, as well as the risks inherent in the payment system.

Macedonian Law: These preconditions go beyond the content of the Macedonian law. Current weak economic conditions, ethnic tensions and recent hostilities, unreliable courts, limited public confidence in financial institutions, and a highly concentrated but small insurance industry indicate that these preconditions are not fully present in Macedonia.

IAIS: An insurance supervisor is expected primarily – to protect policyholders by ensuring that companies comply with the legislation and regulations governing the business of insurance; - to maintain efficient, fair, safe and stable insurance markets for the benefit and protection of policyholders.

Macedonian law: The Macedonian Insurance Supervision Department is at present very small, with six professionals on staff. It is only a year and a half old. While the present Head of Department and her staff appear to be highly competent and motivated, they have limited resources to discharge substantial obligations. The new law provides detailed and thorough provisions intended to assure the safe and constructive operation of the insurance industry, but it will require significant resources to enforce.

IAIS: In particular, the insurance supervisor should be operationally independent and accountable in the exercising of its functions and powers; have adequate powers, legal protection and financial resources to perform its functions and exercise its powers; ... clearly define the responsibility for decision making; and hire, train and maintain staff with high professional standards who also follow the appropriate standards of confidentiality.

The insurance supervisor is operationally independent from both political authorities and the insurance companies that it supervises in the execution of its supervisory tasks and is accountable in the exercise of its functions and powers.

Macedonian law: The Insurance Supervision Department appears to be independent of the insurance industry that it regulates. The new law gives it adequate powers – and specific standards – to apply, but it is not clear that it has adequate resources to carry out its mandate.

IAIS: The insurance supervisor had adequate powers, legal protection and proper resources and staff, and the capacity to perform its functions and its powers.

Insurance supervisors must have the power to take remedial action where problems involving licensed companies are identified.

The insurance supervisor has the right to withdraw the license on grounds of substantial irregularities, e.g. if the company no longer meets the licensing requirements or seriously infringes the law in force.

Macedonian law: The new law grants the supervisor the authority to take remedial action and to withdraw an insurer's license where warranted. (Section 11; Section 12, Chapter 2.) What is uncertain is whether the supervisor will have adequate resources to fully carry out the mandates of the new law.

IAIS: Adopt a clear, transparent and consistent regulatory and supervisory process.

The responsibilities of the insurance supervisor are clear and objectively stated.

The insurance supervisor adopts a clear, transparent and consistent regulatory and supervisory process. The rules and procedures of the insurance supervisor are published and updated regularly.

Macedonian law: The new law is unusually clear and transparent as to both its substantive standards and its procedures. It clearly states the responsibilities of the insurance supervisor. It provides for the issuance of implementing regulations. (Sections 11 and 12.)

IAIS: A process should be established for ensuring that external audits of insurance companies operating in the jurisdiction are acceptable.

If its own capacities are not sufficient, the insurance supervisor should be able to outsource to third parties (e.g. auditors, actuaries) supervisory tasks such as on-site inspections and monitoring in the solvency position or the sufficiency of technical provisions (policy liabilities).

The insurance supervisor requires that information is verified periodically through on-site examinations conducted by himself, external auditors or other qualified parties.

The insurance supervisor has the authority to require insurers to hire using their own resources, independent auditors or actuaries for auditing or reviewing all or specific items of financial statements whenever the insurance supervisor has doubts as to their accuracy.

Macedonian law: The new law provides for external audits of insurers and authorizes outsourcing to auditors and actuaries, who are given substantial roles under the law. The law authorizes on-site examinations. The law requires insurers to use auditors and actuaries at their own expense to certify their financial statements. (Sections 9, 11, and 12.)

IAIS: Companies wishing to underwrite insurance in the domestic insurance market should be licensed. Where the insurance supervisor has authority to grant a license, the supervisor in granting a license, should assess the suitability of owners, directors, and/or senior management, and the soundness of the business plan, which could include pro forma financial statements, a capital plan and projected solvency margins.

Legal provisions on licensing are in place through the insurance law.

These legal provisions define the types of company or entity that are insurance companies or entities, and the insurers which must be licensed or define insurance business and prescribe that all of entities writing insurance business must be licensed.

A company licensed to operate life insurance should not also be licensed to operate non-life insurance and vice versa, unless there are clear provisions, which the insurance supervisor finds satisfactory, requiring that risks be handled separately on both a going concern and a winding-up basis.

Macedonian law: The new law provides detailed and specific provisions for licensing of insurers. Non-licensed insurers are not permitted to operate in Macedonia. The law does not require separate companies for life and non-life insurance. This condition most likely reflects the fact that QBE Insurance, the only Macedonian insurer that writes life insurance, is both long-standing and writes only a miniscule amount of life insurance. (Section 3.)

IAIS: The insurance supervisor should review changes in the control of companies that are licensed in the jurisdiction. The insurance supervisor should establish clear requirements to be met when a change in control occurs. These may be the same as, or similar to, the requirements which apply in granting a license. In particular, the insurance supervisor should: require the purchaser or the licensed insurance company to provide notification of the change in control and/or seek approval of the proposed change; and establish criteria to assess the appropriateness of the change, which should include the assessment of the suitability of the new owners as well as any new directors and senior managers, and the soundness of any new business plan.

The law defines such changes and permits the insurance supervisor to take into account the substance as well as the form of the transaction.

The insurance supervisor has the authority to refuse or revoke a license if the organizational (or group) structure of the applicant or licensee hinders the effective supervision.

Macedonian law: The law includes provisions applicable to the transfer of insurance portfolios. (Section 3, Articles 42-44.)

IAIS: ... the supervisor in granting a license, should assess the suitability of owners, directors, and/or senior management.

Legal provisions exist on whether key functionaries such as owners, directors and/or senior managers are fit and proper (i.e., possessing the necessary knowledge, skills and integrity of their positions).

The insurance supervisor should establish criteria to assess the appropriateness of the change, which should include the assessment of the suitability of the new owners as well as any new directors and senior manager ....

The insurance supervisor requires that insurance entities (insurers and intermediaries) have key functionaries who are and remain fit and proper for their roles (i.e., possessing the necessary knowledge, skills and integrity for their positions), and has effective means to enforce this. (Market conduct)

Macedonian law: The law contains detailed provisions governing the suitability and fitness of key functionaries and their continuing fitness for their positions. (Section 2.) It also includes provisions for the certification of actuaries and the licensing of brokers. (Sections 5 and 10.)

IAIS: Corporate Governance. It is desirable that standards be established in the jurisdiction which deal with corporate governance. Where the insurance supervisor has responsibility for setting requirements for corporate governance, the supervisor should set requirements with respect to: the roles and responsibilities of the board of directors.

The insurance supervisor has the authority to require boards of directors to clearly set out their responsibilities towards acceptance of and commitment to the specific corporate governance principles for their undertaking.

Macedonian law: Sections 2 and 3 of the new law set forth detailed corporate governance provisions.

IAIS: The supervisor has the legal authority to require companies to submit information on both a solo and a consolidated basis, on their financial condition and performance.

...The insurance supervisor should ensure that no foreign insurance establishment escapes supervision.

Macedonian law: Section 11 of the new law includes detailed requirements for reporting information to the insurance supervisor.

IAIS: The insurance supervisor should be able to: carry out on-site inspections to review the business and affairs of the company ....

The supervisor has a framework for on-going monitoring of the condition and performance of the companies.

The insurance supervisor requires that information is verified periodically through on-site examination conducted by himself, external auditors or other qualified parties.

Macedonian law: Section 8 of the new law provides for internal audits, Section 9 provides for external audits on an annual basis, and Sections 11 and 12 provide detailed provisions for supervision, including on-site examinations.

IAIS: ... The information needed to carry out this review and analysis is obtained from financial and statistical reports that are filed on a regular basis, supported by information obtained through special information requests, on-site inspections and communication with actuaries and external auditors.

....

The insurance supervisor should be able to request and receive any information from companies licensed in his jurisdiction, whether this information be specific to a company or be requested of all companies.

....

Macedonian law: The new law provides for the reporting of information to the insurance supervisor and authorizes the supervisor to obtain information through special requests and on-site examinations. (Sections 11 and 12, including Articles 207 and 208.)

IAIS: Insurance supervisors must have the power to take remedial action where problems involving licensed companies are identified. The supervisor must have a range of actions available in order to apply appropriate sanctions to problems encountered....

The insurance supervisor ensures that remedial actions are taken in a timely manner....

Macedonian law: Section 12 includes authority for the Ministry of Finance to issue orders to eliminate violations; it also includes authority to revoke an insurer's license. Detailed procedures for such actions are included in the law.

IAIS: ... the supervisor may choose to rely on the work carried out by an insurance supervisor in another jurisdiction ....

... the creation of a cross-border insurance establishment is subject to consultation between host and home supervisors ....

Macedonian law: Section 3 of the new law includes detailed provisions relating to the supervision of insurers from foreign countries and cooperation with insurance supervisory authorities in other countries. (See also Section 11, Article 159.)

IAIS: All insurance supervisors should be subject to professional secrecy constraints in respect of information obtained in the course of their activities, including during the conduct of on-site inspections....

Macedonian law: Section 5 of the new law sets forth detailed standards to protect the confidentiality of data.

IAIS: The insurance supervisor requires insurers to have in place comprehensive risk management policies and systems capable of promptly identifying, measuring, reporting and controlling the risks associated with investment activities that might affect the coverage of technical provisions (policy liabilities) and/or solvency margins (capital).

....

Standards should be established with respect to the assets of companies ....

Insurance supervisors should establish standards with respect to the liabilities of companies ....

The insurance supervisor should consider the amount of credit allowed to reduce liabilities for amounts recoverable under reinsurance arrangements ....

The insurance supervisor must be able to review reinsurance arrangements ....

Macedonian law: Section 4 of the new law contains detailed provisions governing the solvency of insurers. It sets forth comprehensive risk management standards, including formulas for the determination of solvency margins for both life and non-life insurers. It includes provisions relating to capital, assets, liabilities, reserves, and reinsurance.

IAIS: The supervisor should be able to: review the internal controls that the board of directors and management approve and apply ....

The supervisor has the authority to require that the insurer has an ongoing audit function ....

Macedonian law: Section 8 of the new law requires insurers to organize internal audit as an independent organizational unit reporting directly to the management board.

IAIS: The requirements regarding the capital to be maintained by companies which are licensed, or seek a license ... should be clearly defined ....

Macedonian law: Section 4 of the new law includes specific requirements for insurers' capital. It includes safety provisions (Article 70) and required solvency margins (Articles 75 and 76) as well as specified "guarantee fund" amounts (Article 77).

IAIS: A process should be established for setting the accounting requirements for the preparation of financial reports in the jurisdiction.

....

The insurance supervisor requires insurance companies to utilize valuation rules that are consistent, realistic and prudent.

Macedonian law: The new law includes requirements for independent audits. It authorizes the Minister of Finance to prescribe the form and content of audit reports. The law includes standards for investments (Section 4, Articles79-98).

IAIS: The supervisor is informed about findings of investigations where the power to investigate fraud, money laundering, and other such activities rests with a body other than the insurance supervisor.

The insurance supervisor has the authority to require that insurers have formal procedures to recognise potential suspicious transactions.

Macedonian law: Section 8 of the new law relating to internal audits provides for submission to the Minister of Finance of the semi-annual internal audit reports, which are required to include any findings as to non-compliance and irregularities. Similarly, Section 9 relating to external audits requires the auditors to inform the Minister of Finance immediately if they find that the insurer has acted in breach of the risk management rules, has encountered a threat of non-liquidity or insolvency, or the safety of insureds is jeopardized.

IAIS: ....

Supervisors should ensure that insurers and intermediaries exercise the necessary knowledge, skills and integrity in dealings with their customers.

....

The supervisor sets policy and guidelines with regard to disclosure to the customer of relevant, meaningful and understandable information in a timely manner.

Macedonian law: Articles 49-52 of the new law include disclosure requirements for insureds. The requirements include specific information as to the insurer, policy terms and conditions, premiums (including any break-down by risk and any additional charges), and other matters, as well as the insured's right to make a complaint to the Ministry of Finance.

Section 5: Recommendations Relating to the Insurance Business and Its Regulation in Macedonia

What is most striking about Macedonian insurance is the pace of growth and development of its regulatory system. Less than two years ago there were only limited insurance laws, no insurance regulatory department, and apparently no insurance regulations. Today there is a competent, hard-working, dedicated staff of six professionals in the Insurance Supervision Department. The Head of the Department, Ms. Aleksandra Naceva, is remarkably knowledgeable and competent for a person 27 years old and strongly dedicated to the creation of an effective insurance regulatory system. Not only have three technical regulations been issued, but a remarkably thorough and well-conceived insurance law has been drafted, approved by the government, and is now pending in Parliament. The draft law, comprised of 252 articles, contains detailed, sound provisions in most areas of concern in the regulation of the business of insurance. As set forth in greater detail in Section 3, the draft law includes effective provisions relating to capitalization, licensing, foreign insurers, solvency margins, investments, reserves, internal audit, financial reporting and examination, licensing of brokers, certification of actuaries, supervision, insolvency, and enforcement. It appears to substantial comply with European Union standards and the core principles of the International Association of Insurance Supervisors. (See Section 4.)

Under the new law, the Insurance Supervision Department has the responsibility to promulgate 24 by-laws, or implementing regulations. This would be a daunting task even for a large insurance department in the United States, much less a new department with a staff of six (including only one lawyer). It also has responsibility for conducting on-site examinations of the four Macedonian insurers (the smallest two of which have recently been completed), financial reporting, and the host of responsibilities of an insurance regulator. Substantial technical assistance has been provided by persons from Germany, Slovenia, and Estonia in the drafting of the new law. It is expected that additional technical assistance will be provided from the same sources in the drafting of the implementing regulations. It would seem desirable, to the extent that adequate technical assistance is not provided from other sources, for USAID to consider providing such assistance to the extent needed. It is unusual to have an opportunity of this nature. Typically, it is difficult and time-consuming to achieve the enactment of a comprehensive insurance regulatory law of good quality. It is also typically difficult to implement and to enforce such a law once enacted. In Macedonia, there is at present the fortunate combination of a highly motivated, competent, and ethical regulatory department; support for the new law by all insurers in the jurisdiction; and the opportunity to establish high quality prudential regulation while the industry is still small and before foreign companies have entered. Accordingly, it would seem to be an excellent investment to foster the development of the new regulatory system at this time, especially when there is some chance that the opportunity might be lost because of political changes.

In addition to assistance in preparing the needed regulations, support of training and education could be very beneficial. Although the Department staff members appear to be competent as well as hard-working, they have limited education, training, and experience in the business of insurance and its regulation. The need is especially great in the more technical areas, such as actuarial science and solvency regulation. Further, there are additional requirements under the new law – such as the licensing of insurance brokers – for which the department lacks resources. In addition, the Department staff would benefit from involvement with international insurance regulatory organizations, such as IAIS, to keep current with best practices in the field and to collaborate with regulators from other countries. Accordingly, financial support in these areas would be beneficial, as would providing short-term or long-term resident experts. It should be noted that Ms. Naceva specifically mentioned the foregoing three areas as ones in which she would appreciate assistance, although she did not propose assistance in drafting regulations or conducting on-site examinations (even of the largest company, QBE Macedonia).

Reliable and affordable insurance coverage is a key element of the infrastructure of a developing economy. Business insurance, by enabling firms to control and quantify risk, helps to provide the foundation for a stable cost structure and profitable development. Business insurance, both property and liability, is important to permit firms to guard against catastrophic exposures (e.g., the destruction of buildings or manufacturing facilities by fire). With respect to less devastating risks, insurance provides a means of transforming losses that are uneven over time and difficult to predict into relatively certain streams of premium payments. As such, the development of a stable, reliable insurance industry to provide business insurance which firms have confidence in is an important objective in a developing economy. An effective regulatory system is a precondition for such insurance. Accordingly, strengthening of the nascent regulatory system in Macedonia should help to promote the economic development desired for the country.

Personal lines insurance – especially coverage of homes against fire and other perils and motor vehicle coverage - is also important. In Macedonia, the same companies that offer business insurance offer personal lines coverage. A striking characteristic of the Macedonian insurance marketplace, however, is that virtually no life insurance is sold. Because of the history of high inflation and frozen bank accounts, there appears to be substantial mistrust of this product. Its development, however, should not be a priority. The sale of life insurance in developing countries is often fraught with abuse (typically excessive prices and high lapse rates), and that business does not generate the levels of investible assets that might be expected. In addition, the risk insured against – premature death – is typically a less severe exposure in terms of economic development needs and person security than other types of coverage. Accordingly, no recommendation to develop this line of insurance is put forward.

Section 6: Pension Issues in Macedonia

Macedonia has in place a compulsory pension system that provides pensions up to 80% of wages on the basis of years of service. This "first-pillar" system is financed on a pay-as-you-go basis. Although monthly payments to pensioners are being met, the system apparently has no reserves; the payments to retirees are being financed by current contributions made by active workers. (Approximately four years ago there was a problem meeting current obligations to retirees.) The rate of contribution to the system is 20% of wages. As the number of retirees grows in relation to the number of active workers, it will become increasingly difficult to finance current retirement benefits from current contributions. This problem will be exacerbated by economic problems, especially high unemployment, which reduces the amount of current contributions. As a result, the system is headed for what might be termed a demographic train wreck.

In response to this situation, a new pension system has been developed. It is based on the addition of a "second-pillar" plan complementing the first pillar, which will be reduced. The second pillar will consist of a defined contribution plan – mandatory for new workers entering the labor force – based on individual accounts comprised of each worker's contributions and investment earnings on them. (See "A Summary of the Macedonian Pension Reform: Policy Parameters, Forecasts, and Financing, Patrick Wiese, June 15, 2000 for a helpful description of the reform, from which this paper draws.) Under the two-pillar system, contributions to Pillar One will be reduced to 13%, while the remaining 7% will be contributed to the Pillar Two accounts. In order to control expenditures under the current system, the maximum replacement rate is being reduced to 72%, pension indexation is changing from 100% of wage growth to 80%

price growth plus 20% wage growth, and retirement ages will increase to 64 for men and 62 for women.

Under the two-pillar system, the maximum Pillar One replacement rate will be reduced to 30%. The missing 42% will presumably be made up from the individual Pillar Two accounts, inclusive of investment earnings. Expected Pillar Two replacement rates depend on complex actuarial and economic projections. Under the new system, workers already covered under Pillar One will be given the opportunity to switch to the combined system. The maximum credit for Pillar One service, however, will be five years of service. As a result, switching will not be favorable for most workers. The exceptions will be young workers with few years of service. (Id.) In fact, one of the complications under the new system will be the determination on a case-by-case basis whether switching is in an individual worker's interest.

As the new system grows, the Pillar Two pension funds will become major and ultimately dominant players in Macedonia's capital markets. According to one analyst, Pillar Two assets are expected ultimately to stabilize around 70% of GDP. (Id.) The inflows of contributions will in fact pose a significant problem in light of the relatively undeveloped status of Macedonia's capital markets. Only one government bond issue is presently traded on the Macedonian Stock Exchange, and the volume of stocks traded is quite low. Because the build-up of capital in the Pillar Two pension funds will be gradual, it would be expected that new investment vehicles will be developed to handle the supply of funds.

New Pension Law. A highly detailed law setting forth the new second pillar system has been drafted and considered extensively; it is now pending in Parliament, where enactment is expected soon. Chapter 2 of the new law sets forth the standards governing pension companies, which under the new system will administer pension funds. This chapter includes detailed corporate governance provisions for the new pension companies. These provisions include standards for members of the boards of management, conflict of interest rules, and legal liability for damages in the event of a failure to perform duties in accordance with the law. Chapter 3 sets forth procedures for the licensing of pension companies. The newly established pension supervisory agency is directed to grant licenses for pension companies on the basis of a competitive public tender. The law contemplates that two pension companies shall be established for an initial period of ten years. Detailed procedures for the tender process are set forth. The law also sets forth detailed procedures for pre-qualification of applicants for licenses as pension companies. The Agency is directed to determine pre-qualification of applicants on the basis of compliance with capital requirements, financial resources, fitness of management, and expected compliance with the objectives of the law.

Chapter 4 of the pension law governs pension funds, which under the law are to be open-end investment funds. This chapter provides that assets of a pension fund shall be owned by its members and may not be claimed by creditors of a pension fund; it also specifies provisions that must be included in the by-laws. Chapter 5 sets forth the rules governing the newly established agency for supervision of full funded pension insurance. The Agency's mission under the law shall be to protect the interests of Pension Fund members and to enhance the development of the fully funded pension insurance system in Macedonia. The Agency is given the duties to operate the tender and licensing processes, supervise pension companies and custodians, monitor financial statements of pension funds and pension companies, issue regulations, and ensure the effective supervision of the fully funded pension insurance and financial sector. The law sets forth detailed corporate governance provisions for the Agency, including the duties of its management board and chairman, as well as establishing its supervisory authority. The law also provides standards for confidentiality. It also sets forth procedures for its budget and fees.

Chapter 6 of the pension law governs the rates of contribution into the pension plan. It specifies that persons who become subject to pension insurance after January 1, 2003, must become members of the new system within three months. The chapter sets forth detailed procedures for becoming a member of a pension fund as well as for payment of contributions and, if applicable, transfers from one pension fund to another governed by a different pension company. Chapter 7 provides for the functions of the pension and disability insurance fund of Macedonia. These functions include receiving and allocating contributions, maintaining records, and preparing reports. Chapter 8 establishes stringent rules relating to the marketing of pension funds. For example, no person may offer collateral benefits for the purpose of persuading a person to join a pension fund. The presentation of potentially misleading information is prohibited, as is marketing of a pension fund at a person's place of employment. Pension companies may enter into membership agreements only through registered sales agents. The Agency is directed to establish procedures for the sales agents' examination and entry into the register of sales agents.

Chapter 9 of the pension law governs the operation of accounts and valuation of assets. It sets forth detailed rules for accounting for and crediting contributions and account valuations. Chapter 10 governs the payment of pension benefits. It provides that in the discretion of a member the balance in his or her account may be used for either purchasing an annuity payable for life or a program of scheduled withdrawals. Chapter 11 sets forth reporting and disclosure obligations. The law requires that every six months a pension company must provide each member with a statement of the assets standing to his or her account. In addition, the law sets forth requirements for pension companies to report to the Agency. Chapter 12 governs fees charged by pension companies. It specifies that fees may be charged only in certain ways, and it specifies procedures that must be followed before fees may be increased. In addition, a maximum fee of 1.2% per annum is established.

Chapter 13 addresses the crucial area of the investment of pension fund assets. It begins by setting forth the governing principles of maximizing returns, solely for the benefit of pension fund members, subject to ensuring the security of pension fund assets, the diversity of investment risk, and the maintenance of adequate liquidity. The chapter sets forth a highly detailed list of permitted investments in fourteen categories, together with maximum proportions of permitted investments in any one asset (by regulations issued by the Agency). The law provides that no more than 20% of the value of the assets of a pension fund may be invested in assets issued by a foreign issuer. The chapter goes on to list a number of prohibited investments, ranging from unlisted securities to physical assets which are not frequently quoted on organized markets and for which valuation is uncertain, to real estate (other than mortgage-backed securities and indirect investment through mutual funds). Prohibitions as to self-dealing are also included.

Chapter 14 governs custodians of pension fund assets. The law requires pension companies to appoint a single custodian for keeping the assets of the pension fund. Custodians are required to keep the assets of each pension fund strictly separate from those of other pension funds. Custodians are subject to conflict of interest rules and minimum capital requirements (20,000,000 Euros if not a currently licensed bank). Custodians must hold any securities securely, maintain records of paperless securities, keep settlement documents, and act as clearing agent. Custodians must have custody agreements in place with the pension company. Custodians shall be liable for damages incurred as a result of the non-performance of their responsibilities, and such damages may not be covered from the assets of the pension fund. Chapter 15 provides for guarantees by the state budget. These guarantees apply in the event of a criminal act involving fraud or theft, the insufficiency of the assets of the governing pension company, or other circumstances recommended by the Agency when it is unlikely that depletion will be made good within six months. Chapter 16 specifies crimes and penalties. Persons in charge of a pension company who falsely present or cover up facts, or illegally use or invest the fund assets, shall be punished with prison from one to five years. Custodians who fail to carry out their legal duties shall be punished with prison up to three years. Fines equivalent to 100,000 to 300,000 denars are to be levied in any of 44 specifically enumerated circumstances. Fines for both pension funds and custodians are set forth for numerous other specified violations. Chapter 17 sets forth transitional provisions; most importantly, it specifies that contributors who become subject to mandatory pension and disability insurance from January 1, 2003, to September 30, 2003 are required to become members of pension funds by December 31, 2003.

Issues of Implementation. The new Pillar Two program raises numerous issues of implementation. How will the administrative apparatus be created? What investment vehicles will be available for the new funds? How will the current system be financed after the contribution rate has been reduced to 13% from 20%? Will the funds of the new contributors be secure? Has sufficient training been undertaken of the persons responsible for the new system? Can participants be sufficiently educated in the time frame allowed? Will current participants in the Pillar One system be properly informed as to the wisdom of electing to participate in the Pillar Two system?

The difficulty of answering the foregoing questions suggests that time will be required to resolve them. The aggressive timetable of the new law may well be too fast, especially given current economic and political conditions. It would be desirable to have more time to work out answers to these questions as well as others not stated.

Recommendations. Ms. Zorica Apostolska, Director of the Pension Reform Project, pointed out that the project lacks sufficient funds to implement the new program. Formerly financed by the World Bank, the project now faces a lapse in financial support from that source until July, 2003. Ms. Apostolska described needs in the following areas: policy development (drafting of regulations); preparation of accounting standards; institutional development of the Pension Supervisory Agency; organization of the public tender; and development of the information system. The total amount indicated is $1.52 US dollars. In light of the complexity and amount of work needed to implement the new Pillar Two system, the tight time-frame established in the new law, and the investment to date in this project, it would appear desirable to extend financial support and technical assistance for this project.

Insurance Market Data - The Republic of Macedonia (1998-2000)

1998
in MKD

Insurance Company	Total Assets	Total Capital	Life Insurance Premium	Non-Life Insurance	Total Premium Income	Paid Damages	Gross Profit	Loss Ratios
1	2	3	4	5	6	7	8	9=7/6
ADOR Makedonija	754,584,868	2,038,318,067	61,394,000	5,213,742,808	5,275,136,808	266,438,076	3,426,539,398	64.96%
Makoshped Insurance	50,481,748	33,662,741	not licensed for	29,230,895	29,230,895	3,438,508	12,938,000	44.26%
Vardar insurance	572,819,415	103,889,627	not licensed for	231,413,541	231,413,541	18,647,381	192,769,142	83.30%
Tabak insurance	312,832,353	113,731,421	not licensed for	78,462,242	78,462,242	11,830,772	24,142,665	30.77%
Vinner broker insurance	25,357,129	13,397,045	2,333,563	not licensed for	233,563	84,586	1,565,680	67.10%
Total	**8,506,075,513**	**2,302,998,901**	**63,727,563**	**5,552,849,486**	**5,616,577,049**	**300,439,323**	**3,657,954,885**	

1999
in MKD

Insurance Company	Total Assets	Total Capital	Life Insurance Premium	Non-Life Insurance	Total Premium Income	Paid Damages	Gross Profit	Loss Ratios
1	2	3	4	5	6	7	8	9=7/6
ADOR Makedonija	9,055,671,775	2,409,793,445	76,520,000	5,442,360,254	5,518,880,254	242,724,110	3,186,385,673	57.74%
Makoshped Insurance	62,178,238	36,973,241	not licensed for	37,996,738	37,996,738	5,162,560	16,816,000	44.26%
Vardar insurance	634,737,974	116,604	not licensed for	340,289,420	340,289,420	13,177,502	265,583,470	78.05%
Tabak insurance	369,231,325	133,687,286	not licensed for	77,661,091	77,661,091	12,146,059	40,881,543	52.64%
Vinner broker insurance	18,484,310	13,242,749	1,340,594	not licensed for	1,340,594	50,014	2,319,881	173.01%
Total	**10,140,303,622**	**2,710,300,724**	**77,860,594**	**5,898,307,503**	**5,976,168,097**	**273,260,245**	**3,511,986,497**	

2000
in MKD

Insurance Company	Total Assets	Total Capital	Life Insurance Premium	Non-Life Insurance	Total Premium Income	Paid Damages	Gross Profit	Loss Ratios
1	2	3	4	5	6	7	8	9=7/6
Kjubi-insurance	10,061,960,889	2,578,703,275	88,467,597	4,839,856,568	4,938,324,165	3,108,853,038	26,762,970	63.10%
Makoshped Insurance	93,341,685	57,283,513	not licensed for	60,340,966	60,340,966	31,406,067	9,346,317	52.00%
Vardar insurance	639,080,554	130,569,526	not licensed for	442,755,909	442,755,909	254,539,833	9,945,347	57.50%
Tabak insurance	378,643,385	150,024,644	not licensed for	62,198,098	62,198,098	31,666,964	10,949,770	50.90%
Vinner broker insurance	not submitted	not submitted	not submitted	not submitted	not submitted	not submitted	not submitted	
Total	**11,173,026,513**	**2,916,580,958**	**88,467,597**	**5,405,151,541**	**5,493,619,138**	**3,426,465,902**	**57,004,405**	

2,000
in DM

Insurance Company	Total Assets	Total Capital	Life Insurance Premium	Non-Life Insurance	Total Premium Income	Paid Damages	Gross Profit	Loss Ratios
1	2	3	4	5	6	7	8	9=7/6
Kjubi-insurance	323,743,915	82,969,861	2,846,448	155,722,541	158,568,989	100,027,447	861,099	63.10%
Makoshped Insurance	3,003,272	1,843,099	not licensed for	1,941,473	1,941,473	1,010,491	300,718	52.00%
Vardar insurance	20,562,437	4,201,079	not licensed for	14,245,686	14,245,686	8,189,827	319,992	57.50%
Tabak insurance	12,182,863	4,827,048	not licensed for	2,001,226	2,001,226	1,018,886	352,309	50.90%
Vinner broker insurance	not submitted	not submitted	not submitted	not submitted	not submitted	not submitted	not submitted	
Total	**359,492,488**	**93,841,087**	**2,846,448**	**173,910,925**	**176,757,373**	**110,246,651**	**1,834,119**	

2,000

in Euro

Insurance Company	Total Assets	Total Capital	Life Insurance Premium	Non-Life Insurance	Total Premium Income	Paid Damages	Gross Profit	Loss Ratios
1	2	3	4	5	6	7	8	9=7/6
Kjubi-insurance	161,871,958	41,484,931	1,423,224	77,861,271	79,284,495	50,013,724	430,550	63.10%
Makoshped Insurance	1,501,636	921,550	not licensed for	970,737	970,737	505,246	150,359	52.00%
Vardar insurance	10,281,219	2,100,540	not licensed for	7,122,843	7,122,843	4,094,914	159,996	57.50%
Tabak insurance	6,091,432	2,413,524	not licensed for	1,000,613	1,000,613	509,443	176,155	50.90%
Vinner broker insurance	not submitted	not submitted	not submitted	not submitted	not submitted	not submitted	not submitted	
Total	179,746,244	46,920,544	143,224	86,955,463	88,378,687	55,123,326	917,060	

2,000

in US $

Insurance Company	Total Assets	Total Capital	Life Insurance Premium	Non-Life Insurance	Total Premium Income	Paid Damages	Gross Profit	Loss Ratios
1	2	3	4	5	6	7	8	9=7/6
Kjubi-insurance	154,017,463	39,471,962	1,354,165	74,083,217	75,437,382	47,586,913	409,658	63.10%
Makoshped Insurance	1,428,772	876,883	not licensed for	923,633	923,633	480,730	143,063	52.00%
Vardar insurance	9,782,344	1,998,615	not licensed for	6,777,212	6,777,212	3,896,217	152,232	57.50%
Tabak insurance	5,795,858	2,296,413	not licensed for	952,060	952,060	484,723	167,607	50.90%
Vinner broker insurance	not submitted	not submitted	not submitted	not submitted	not submitted	not submitted	not submitted	
Total	171,024,438	44,643,823	1,354,165	82,736,133	84,090,296	52,448,583	872,561	

* Data according to the annual accounts of the insurance companies.

Survey of Written Premiums from Vardar Insurance
Skopje, Macedonia
1999-2001
(All figures are in Euro's)

No	Types of Insurance	Sector	1999	2000	Plans for 2001	Index 6:4	2000%
1	Civil	Legal Entities	779,557	782,197	965,656	123.9	
		Physical Person	42,311	45,393	69,689	164.7	
		Total	821,868	827,590	1,035,345	126	31.90%
2	Industry	Legal Entities	855,738	977,869	1,323,689	154.7	
		Physical Person	-	-	-	-	
		Total	855,738	977,869	1,323,689	154.7	40.70%
3	Tillage Crops and Fruit Crops	Legal Entities	52,705	102,443	251,738	477.6	
		Physical Person	96,705	101,689	106,770	110.4	
		Total	149,410	204,132	358,508	240	11.00%
4	Animals	Legal Entities	28,049	62,754	110,328	393.3	
		Physical Person	32,984	36,984	60,738	184.1	
		Total	61,033	99,738	171,066	280.3	5.30%
5	Goods in Transport	Legal Entities	198,246	118,164	173,934	87.7	
		Physical Person	-	-	-	-	
		Total	198,246	118,164	173,934	87.7	5.40%
6	Credits	Legal Entities	33,213	99,902	104,754	315.4	
		Physical Person	-	-	-	-	
		Total	33,213	99,902	104,754	315.4	3.20%
7	Other	Legal Entities	68,885	53,361	82,393	119.6	
		Physical Person	-	-	-	-	
		Total	68,885	53,361	82,393	119.6	2.50%
Property Insurance		Legal Entities	2,016,393	2,196,690	3,012,492	149.4	
		Physical Person	172,000	184,066	237,196	137.9	
		Total	2,188,393	2,380,756	3,249,688	148.5	100%

No	Types of Insurance	Sector	1999	2000	Plans for 2001	Index 6:4	2000%
8	Comprehensive Automobile Liability	Legal Entities	948,902	1,261,295	1,500,721	158.2	
		Physical Person	629,623	870,656	1,055,984	167.7	
		Total	157,525	2,131,951	2,556,705	162	41.50%
9	TPL	Legal Entities	668,869	899,863	1,415,869	211.7	
		Physical Person	615,033	698,279	1,013,557	164.8	
		Total	1,283,902	1,598,142	2,429,426	189.2	39.40%
10	Aviation Liabiltiy	Legal Entities	-	214,852	214,754	-	
		Physical Person	-	-	-	-	
		Total	-	214,852	214,754	-	3.50%
11	Green Card	Legal Entities	559,672	688,410	960,885	171.7	
		Physical Person	-	-	-	-	
		Total	559,672	688,410	960,885	171.7	15.60%
Insurance of Motor Vehicles		Legal Entities	2,177,443	3,064,420	4,092,229	187.9	
		Physical Person	1,244,656	1,568,935	2,069,542	166.3	
		Total	3,422,099	4,633,355	6,161,771	180.1	100.00%
12	Automobile Accident	Legal Entities	-	-	-	-	
		Physical Person	151,475	171,082	327,737	216.4	
		Total	151,475	171,082	327,737	216.4	30.30%
13	Collective Accident	Legal Entities	-	-	-	-	
		Physical Person	435,557	512,672	752,607	172.8	
		Total	435,557	512,672	752,607	172.8	69.70%
Personal Insurance		Legal Entities	-	-	-	-	
		Physical Person	587,032	683,754	1,080,344	184	
		Total	587,032	683,754	1,080,344	184	
TOTAL		Legal Entities	4,193,836	5,261,110	7,104,721	169.4	
		Physical Person	2,003,688	2,436,755	3,387,082	169	
		Total	6,197,524	7,697,865	10,491,803	169.1	100.00%

ANNEX 5: LIST OF MEETINGS

Goran Ancheski, Head of International Finance Department, Ministry of Finance

Snezana Andova, General Manager, Moznosti

Zorica Apostolska, Ministry of Labor and Social Policy

Milica Arnaudova, Head of Methodology Unit, Supervision Department, National Bank of the Republic of Macedonia

Dimitris Beis, Greek Business Development, Kreditna Banka

Gligor Bishev, First General Manager, Stopanska Banka

Liljana Bozinovska, Director, Deposit Insurance Fund Skopje

H. Peers Brewer, Chief of Party, Macedonian Banking Project, Booz Allen & Hamilton

Jasmina Bucevska, Adviser to the Management Board, Komercijalna Banka

Lazar Cvetkovski, General Manager, Komercijalna Banka

Neils Ekberg, Chief of Party, USAID Investment Development/Capital Markets Project, Price Waterhouse Coopers

Joseph Fischl, Chief of Party, USAID Accounting Reform Project

Robert Gourley, World Bank

Ilija Graorkovski, Manager, Supervision Department, National Bank of the Republic of Macedonia

Aleksandar Ignjatovski, Manager, Tutunska Banka

Vesna Ivanovska, Program Assistant, Financial Services Volunteer Corps

Tom Jersild, ABA/CEELI

Gazmend Kadriu, Ernst & Young (and Advisor to the Management Board of Tutunska Bank)

Maja Karlgova, Tabak Insurance Company

Jasminka Kirkova, General Manager, Makedonska Banka

Margareta Lipkovska-Atanasov, Ministry of Labor and Social Policy

Verica Markovska Hadzi-Vasileva, Ernst & Young

Dragan Martinovski, State Adviser, Ministry of Finance

Jan Mikkelsen, Resident Representative, IMF

Kiril Minoski, Deputy Project Manager, Macedonian Banking Project, Booz Allen & Hamilton

Normans Mizis, World Organization of Cooperative Credit Unions

Aleksandra Naceva, Insurance Supervision Department

Aneta Naumovska, Director, Research Department, National Bank of the Republic of Macedonia

Martha Ninichuk, Program Director, World Council of Credit Unions

Snezana Osmanli, National Insurance Bureau

Tatjana Pancic, Program Officer, Financial Services Volunteer Corps

Vladimir Pesevski, SEAF Macedonia

Mr. Popovski, Makoshped Insurance Company

Anthony Randazzo, Regional Director, Financial Services Volunteer Corps

Sonja Stefanovska, Vardar Insurance Company

Kiopcevski Stojan, Vardar Insurance Company

Vesna Takovska, Tabak Insurance Company

Tomo Tomovski, Head, Securities Exchange Commission

Jasminka Varnalieva-Bidzovska, Private and Financial Sector Development Officer, World Bank

Dragana Vukobrat, Deputy Manager, Supervision Department, National Bank of the Republic of Macedonia

Phil Wiseman, QBE Macedonija

Eleonora Zgonjanin-Petrovic, General Manager, Central-Skopje Savings House

Evgeni Zograkski, CEO, Macedonian Stock Exchange

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